S. HRG. 100-676

OVERSIGHT HEARING ON THE COMMODITY FUTURES TRADING COMMISSION

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

REVIEWING THE PERFORMANCE OF THE COMMODITY FUTURES TRADING COMMISSION IN CARRYING OUT AGENCY'S DUTIES AND RESPONSIBILITIES AND REGULATING THOSE MARKETS FALLING UNDER ITS JURISDICTION

JULY 15, 1987

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OVERSIGHT HEARING ON THE COMMODITY FUTURES TRADING COMMISSION

WEDNESDAY, JULY 15, 1987

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The committee convened, pursuant to notice, at 10:08 a.m., in room SR-332, Russell Senate Office Building, Hon. Patrick J. Leahy (chairman of the committee) presiding.

Present or submitting a statement: Senators Leahy, Melcher, Harkin, Daschle, Lugar, Cochran, McConnell, and Bond.

STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM VERMONT

The CHAIRMAN. The committee will come to order.

I note two things at the start. Both parties are having caucuses and meetings at the moment. We have a debt limit expiration today, a matter of some interest to the rest of the government and to us, partly for the orderly flow of government, the preservation of democracy in the United States, and the ability to recess for the rest of the week, not necessarily in that order. But the combination of those various factors is enough to bring most Senators to their individual party caucuses where they determine just how to do these things.

The other comment is there will be a cloture vote around 10:30 and we will break for a couple of minutes for that.

We are meeting today to review the performance of the Commodity Futures Trading Commission in carrying out that agency's duties and responsibilities and regulating those markets falling under its jurisdiction.

From time to time, as is appropriate and necessary, the committee will review the activities of the Commission, and the markets, traders, and other individuals covered by the Commodity Exchange Act. This is an area that I have taken a particular interest in during the years that I have been a member of this committee and continue to, of course, as chairman.

I have asked Chairman Phillips to focus her comments today on three important public policy issues facing the Commission: program trading, which involves the use of stock index futures in conjunction with equity investments and the possible impact, if any, such a trading system has upon the stock markets; international competition and whether or not the same level of regulation will be applied to both domestic and foreign futures; and finally, those off-

exchange instruments and how some of these instruments which have characteristics of futures and options should be regulated.

Although we will attempt to focus on these three issues, the Members of course are free to ask any questions they desire.

I might say incidentally on behalf of myself and the rest of the committee that we welcome the Chairman of the CFTC, Susan Phillips, here. She will be presenting the views of her Agency at this hearing. I mention this especially in light of her recent resignation, which is effective July 24. I would like to extend to you the thanks of the whole committee for your efforts, your outstanding achievements over the last several years as both a Commissioner and as Chairman. You have led the CFTC into the respected regulatory body it is today, and we are all grateful to you for that. I think everybody in the country should be. And I hope you will leave with us today your ideas and views on what lies ahead for the industry and the CFTC in these changing times.

I also personally want to wish you the best back in Iowa. After the past week or so here in Washington, many of us envy your opportunity to go back there. But you have left your mark, and you deserve the praise that you have received upon leaving.

Before we go to Chairman Phillips opening statement, I would like to advise those with us today that a fourth issue has come to the committee's attention and will be discussed today.

On November 14, 1986, the Securities and Exchange Commission (SEC), announced a settlement agreement with Mr. Ivan Boesky. Now, that had been something that had been in negotiation for some months.

Some time ago, my committee became aware that Mr. Boesky had been involved in the commodities futures market; he had been trading in stock index futures. In fact, he traded in these futures, not only during, but after his negotiations with the SEC.

We have requested and we have received information from the CFTC confirming Mr. Boesky's participation in these markets. And hopefully this morning's hearing will clarify some of the areas regarding Mr. Boesky's activities in the futures market; activities that he took while he was negotiating a settlement agreement and in fact while he was liquidating his stock positions.

Incidentally, I should point out that the CFTC has cooperated completely in replying to all requests of this committee, and we have a letter from the Chairman of the CFTC, giving a summary of the market positions of Ivan Boesky and associated persons and entities. The letter, although not the specific numerical attachments, will be made part of the record.

[The letter of July 13, 1987, and the prepared statement of Senator McConnell follow:]

COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W., Washington, D.C. 20581
(202) 254-6970

Susan M. Phillips
Chairman

July 13, 1987

The Honorable Patrick J. Leahy
Chairman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
328A Russell Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

In response to your letter of June 23, 1987, we have compiled data from our files on the market positions of Ivan Boesky and associated persons and entities.

The attached schedules show the reportable futures positions of Ivan Boesky during the period May 15, 1986, through November 14, 1986. Our records indicate no reportable activity in futures options at that time. Each daily futures position listed is for all futures delivery months combined for all accounts known to be owned or controlled by Mr. Boesky.

Mr. Boesky's most significant futures positions were in stock index futures on the Chicago Mercantile Exchange and the New York Futures Exchange. While these positions never exceeded each exchange's speculative position limit of 5,000 contracts, on a few days, Boesky held limit positions on the short side of the market.

While the Commission has no information on the size of any stock portfolios that Mr. Boesky owned, as a major risk arbitrageur we would expect him to have substantial long stock positions. Short futures positions could have been used to hedge those stock positions from the risk of a broad decline in stock prices. However, if Mr. Boesky's stock holdings were heavily concentrated in stocks that were potential merger targets, short futures positions in indices like the S&P 500 and the NYSE Composite may not necessarily have provided good price protection from the risks associated with owning those stocks.

Also attached is a price chart comparing Mr. Boesky's positions in S&P 500 futures to movements in that index. During the period in question, he was first short futures in a rising

market (last half of June). When he re-entered the market in mid-August, he was short futures in a declining market and was short 5,000 S&P 500 contracts on September 11 and 12, 1986, when the S&P September futures declined a total of 18.45 points. During that broad market move, the Dow Jones Industrial Average declined 120 points on record volume on those two days.

Mr. Boesky briefly held long S&P 500 futures positions during the last half of October, a period of rising prices. He then was short futures during the first half of November when prices had little trend.

Mr. Boesky established short futures positions in the NYSE Composite index on September 12, 1986, and remained short that market through November 14. During that longer period stock prices generally rose.

We wish to remind you that we are furnishing you this information about the market positions of Mr. Boesky pursuant to your request on behalf of the Committee in accordance with the provisions of Section 8(e) of the Commodity Exchange Act. This information has not and may not be made public by the Commission except in compliance with the exceptions to the confidentiality provisions of the Act.

Finally, in your letter of July 7, 1987, you further requested any transcripts of recorded surveillance meetings occurring between October 1, 1986, through November 30, 1986, and also copies of any memoranda exchanged between Commissioners as well as any notes, minutes, or transcripts of recordings of any staff briefings, pertaining to Mr. Ivan Boesky and any futures positions or options on futures, which Mr. Boesky may have held or controlled. We have not found any pertinent documents or information.

Sincerely,

Susan M. Phillips

Susan M. Phillips
Chairman

Enclosures

Note: Enclosures are retained in the committee's file.

Statement of Senator Mitch McConnell

CFTC Oversight Hearing

July 15, 1987

Mr. Chairman:

I welcome the opportunity to hear the testimony of the Chairman of the Commodity Futures Trading Commission, Susan M. Phillips. I will certainly listen with interest to hear her perceptions of the challenges facing the commodities exchange industries, and what the CFTC is doing to help meet those challenges. In addition, I think it will be important to learn how the CFTC is responding to the changes made during last year's reauthorization.

American agriculture is struggling to become more competitive, and to return to profitability, and in this attempt, farmers turn to new techniques of marketing and management. Certainly foremost among these techniques are the financial instruments made available through the various commodity exchanges. Our hearings take on importance today as we examine how we can make these markets more responsive to the needs of American agriculture, and what we can do to allow the commodity exchanges be more responsive to the dynamics of a changing marketplace.

A specific concern of mine along these lines lies in the area of product innovation. As the futures industry attempts to be sensitive to the evolving risk management needs of our agricultural and financial markets, it is my understanding, innovation and

responsiveness has been hindered by regulatory requirements imposed by the CFTC in the contract approval process. Currently, when an exchange detects a need for a new risk management vehicle or a marketing opportunity, it may be unable to respond to the need or the opportunity for 6 months to a year or more because of the time it takes to obtain regulatory approval of a proposed new contract. In an effort to expedite the process, review deadlines were built into the Commodity Exchange Act. However, it is my understanding that these Congressional efforts have not alleviated the problem.

The problem is most glaring with respect to financial futures products with similar products under securities jurisdiction. Futures and options markets are becoming increasingly a part of everyday risk management and investment practice. Participants in the cash markets are more sophisticated now and are more cognizant of the benefits of using futures and options markets to meet financial management goals. However, while the demand for these markets is greater than ever, the CFTC'c contract approval process handicaps the ability of futures markets to provide valuable services in a timely manner, especially in comparison to securities products.

CFTC-regulated exchanges are competing increasingly with SEC-regulated exchanges, domestic off-exchange entities, and exchange and off-exchange products in foreign countries. The SEC's approval process takes a fraction of the time of CFTC's approval process: two months for an SEC regulated stock index option versus 6 to 10

months for a CFTC-regulated stock index option. I understand that this problem has improved marginally, but the situation remains. Little if any approval process is required in the case of competitive, comparable domestice off-exchange and foreign products. This regulatory disparity could destroy the competitiveness of our domestic futures industry, where history has shown that the first exchange to offer a given futures or options product is the most likely to establish successful trading in that product.

I think it is important that the CFTC ensure that the new contract approval process enhances the quality of the product without ensuring its demise due to the length of the process. The Congressional intent regarding new contract approval, in my opinion, was, and still is, to ensure that the futures and options markets do not adversely affect the economy while making the maximum possible contribution to our nation's economy. The futures and options market have proven that they are enormously important and beneficial to our farmers, to agribusiness, and to our economy. The contract designation process should not be permitted to harm the viability and competitiveness of the domestic futures and options markets.

It is to this end that I will ask the following questions:

1) Do you agree, Madam Chairman, that the increase in alternatives to traditional futures products requires that the contract approval process be as expeditious as possible?

2) Don't you agree, Madam Chairman, that a futures exchange should not experience a competitive disadvantage to a securities exchange regarding the ability to trade new products solely because of disparate regulatory approval periods?

I understand that the Commission has received several petitions to remedy this competitive problem of a lengthy new product approval period. I urge the Commission to act favorably on those petitions to ensure the continued competitiveness of the United States futures industry. In particular, I urge the Commission to reconsider its requirement that options on a futures contract must be delayed until trading volume in the underlying futures contract reaches specific levels because of the anti-competitive effect this requirement has regarding a similar securities option product which has no comparable requirement.

I thank the Chair.

The CHAIRMAN. Ms. Phillips, we will yield to you for your statement.

STATEMENT OF HON. SUSAN M. PHILLIPS, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION; ACCOMPANIED BY COMMISSIONERS KALO A. HINEMAN, FOWLER C. WEST, WILLIAM E. SEALE, AND ROBERT R. DAVIS

Ms. PHILLIPS. Thank you very much, Mr. Chairman and members of the committee, I appreciate this opportunity to appear before you today, and I particularly appreciate your very kind remarks. I expect this is my last appearance before this committee as Chairman of the Commodity Futures Trading Commission.

I want to tell you how much I have enjoyed working with this committee the last several years. The committee and its staff have been most constructive in their efforts to oversee the Commission during a period when the regulated markets are undergoing significant change. The oversight process has been healthy.

I believe the current regulatory environment for futures trading, fashioned and refined through reauthorization, speaks for itself. The industry regulated by the CFTC is vibrant and growing, and the Commission has active and complete regulatory, surveillance and enforcement programs to prevent manipulation, fraud and other trading abuses. I appreciate the time you have given to legislative and oversight initiatives, and I thank you for your interest in the Commission's activities.

With me today are the other members of the Commission that I would like to introduce to you: Commissioner Kalo Hineman, on my immediate right, a cattleman, wheat farmer, State legislator, banker and veterinarian from the State of Kansas; Fowler West, on my far right, long-time staff director of the House Agriculture Committee, also with great understanding of agricultural issues; Bill Seale, on my immediate left, an agricultural economist long associated with this committee, and with significant experience with a major futures exchange; Bob Davis, on my far left, an economist who came to us from the staff of the Joint Economic Committee, and who also has banking and international experience.

With your permission, I would like to submit testimony for the record that details the Commission's progress in implementing the 1986 reauthorization legislation and other Commission activities since hearings for that legislation. It also responds more completely to your requests relating to off-exchange instruments, the regulation of foreign futures and options, and program trading. In the interest of time, I would propose only highlighting the testimony, particularly with respect to the three topics in which the committee expressed interest.

The CHAIRMAN. The whole statement will be made part of the record.

Ms. PHILLIPS. Thank you very much, Mr. Chairman.

OFF-EXCHANGE ISSUES

The centerpiece of the Commodity Exchange Act's regulatory scheme calls for futures contracts to be traded on exchanges, subject to self-regulation and oversight by the Commission. The act,

however, does provide for certain narrow exceptions to the general requirement of exchange trading—the cash forward exclusion, the Treasury amendment, dealer and trade option exemptions and leverage.

In the last 2 years, the Commission has had to confront a wide variety of innovative and sophisticated over-the-counter instruments that have characteristics similar, or identical, to those of exchange-traded futures and options. These new products are said to offer highly customized terms, operational efficiencies, potentially lower transactions costs and greater profitability than exchange-traded contracts. To date, the Commission has not been inclined to hinder the introduction of these instruments, except in those instances where they clearly are illegal, off-exchange contracts.

Because of the policy issues raised by these complex new instruments, the Commission has established an internal staff task force to examine the instruments and to recommend a general framework within which the Commission can address these new instruments and markets. The task force is now directing its attention to several specific areas.

The first area relates to a June 1986 no-action letter issued by the Commission's General Counsel, stating that it would not recommend enforcement action where an export trading company proposed to offer an off-exchange hedging service via a "financial credit arrangement" to other commercial entities engaged in export or international trade. That service is now awaiting approval of the Federal Reserve Board and CFTC staff is in contact with relevant Board staff on the matter.

Another developing off-exchange activity being examined by the task force is bank-financed precious metals programs. I might mention also that this is being considered by the Commission's Advisory Committee on CFTC-State Cooperation chaired by Commissioner Fowler West.

Foreign currency trading is another type of over-the-counter trading, which has been somewhat controversial due to varying interpretations of the Treasury Amendment. Because the comments to the Commission in this area indicated widely divergent views on the scope and intent of the Treasury Amendment, the Commission's task force is taking a second look at these questions.

One additional area of increasing off-exchange commercial trading is the hybrid instrument used to raise capital through a public securities issue.

The Commission's responsibility over these hybrid instruments turns largely upon whether they are determined to be futures or option contracts. More often than not, the instruments contain elements of options, forward contracts and futures, but do not fit neatly into any of these categories.

We will continue our examination of these transactions and, if appropriate, will undertake regulatory initiatives or make legislative recommendations to Congress in the future. As the study proceeds, there will be ample opportunity for public comment. We will keep the committee apprised as the work of our task force progresses in this area.

FOREIGN FUTURES AND OPTIONS

As the committee is aware, presently pending before the Commission are proposed rules to govern the offer and sale of foreign futures and option contracts in the United States.

Today, foreign futures may be sold in the United States free of any regulation. Foreign options, on the other hand, are banned generally, although there is a commercial exemption for option purchasers.

Regulations have been proposed that would lift the ban on foreign options and would put into place a regulatory structure for foreign futures and options.

As a result of an extensive comment process, the Commission staff has prepared a recommendation with respect to amendments to the proposed rules that the Commission will consider at a public meeting next week. These amendments will address those issues of primary concern to the commenters, including capital adequacy, protection of customer funds, and the commercial exception.

Let me assure the committee that the Commission is committed to the adoption of regulations governing the offer and sale of foreign futures and options. In view of the increasing internationalization of the markets, the Commission believes it is imperative that regulations be put into place now in order to assure adequate protection of U.S. customers.

STOCK INDEX FUTURES ACTIVITY

Another area to which the Commission has devoted considerable attention in the past year has been the interaction between stock index futures markets and the underlying securities markets. Much public attention and regulatory effort has been focused on the issues of whether certain uses of stock index futures and options, such as program trading, have contributed to increased price volatility in the securities markets and whether additional regulatory measures are warranted.

Broadly defined, program trading is a stock market trading technique that actually predates the inception of stock index futures and option markets. Program trading generally is characterized by institutional sales or purchases, which are often computer-aided, of large baskets of stocks. A subset of such trading activities called "stock index arbitrage" and, sometimes loosely, "program trading," is the purchase or sale of a basket of stocks based on computer-identified price discrepancies between stock index futures or options contracts and their theoretic or fair market value relative to the underlying indexes. As a result of such arbitrage, misalignments between derivatives and stock market prices are reduced or eliminated, and hedging is thereby facilitated.

The principal derivative instrument used for these types of sophisticated trading strategies is the S&P 500 stock index futures contract of the Chicago Mercantile Exchange [CME]. In addition to being the largest stock index futures market, that contract also is one of the most actively traded futures in the industry. It is heavily used by traditional securities industry participants, such as broker-dealers, investment bankers, pension funds, insurance companies, and other securities portfolio managers for hedging or risk shifting,

asset allocation, arbitrage or other forms of risk management techniques.

When unwinding hedged positions at expiration, it is critical to arbitrageurs to obtain the same price for the baskets of stocks they buy or sell as the settlement for the futures and option contracts. Thus, when the expiration of a stock index futures contract requires large arbitrage positions to be liquidated, large orders that may result in stock price volatility are brought to the stock market at expiration.

Consequently, much of the attention to "program trading" has centered on the so-called "third Fridays" or "triple witching days," when there are contemporaneous expirations of the major stock index futures and option contracts, as well as stock options.

Since the futures and option markets have proved to be so valuable to the securities industry, the Commission has worked closely with the Securities and Exchange Commission and with futures and securities exchanges to examine and develop appropriate, coordinated regulatory responses to these perceived problems. We believe these joint endeavors have been productive, and the level of cooperation and coordination among the securities and futures regulators has been excellent. Both agencies consistently have sought regulatory responses to concerns about the derivative markets that would not unduly impair their economic utility.

One of the first steps taken was to assure that the regulatory and self-regulatory authorities were cooperating in the exchange of surveillance information regarding these markets. The SEC and the NYSE also have taken steps to reduce the potential for disorderly markets by publicly announcing the size and direction of the order imbalances in 50 actively traded stocks in the S&P 500 index. The publication of these order imbalances encourages other securities traders to enter orders on the opposite side, thereby helping to alleviate the price effect of large market-on-close orders.

The June 1987 expiration was of particular interest because it was the first expiration following the introduction of a very significant contract modification. The CME amended the terms of its S&P 500 futures contract—and the option on the futures—to terminate trading on the Thursday afternoon preceding the third Friday and to settle based on the opening NYSE quotations the following day. This change was based in large part on the belief that the NYSE's opening procedures were more suited to accommodating order imbalances with minimal price impact than were its closing procedures. This last quarterly expiration proceeded very smoothly despite significant open interest going into the close. There were no significant price moves in the futures, options, or securities markets on the June 18 close nor on the open or close of the stock market on June 19.

As the committee is aware, the CFTC and SEC also have conducted several special studies to determine whether activity in derivative markets was a significant cause of unusual price movements on certain nonexpiration days in the stock market. The SEC's report of trading on September 11-12, 1986—when the Dow Jones Industrial Average dropped 120 points—was published in March of this year. CFTC staff participated in the preparation of that report.

Separately, CFTC Commission staff recently completed an in-depth study of trading activity on January 23, 1987, a day when the Dow Jones Industrial Average fell about 115 points in approximately 70 minutes. I have provided a copy of this report to the committee.

The CHAIRMAN. We will put a copy of that study in the record, and the study [1] will be available to the public.

Thank you.

Ms. PHILLIPS. I appreciate that. We did submit the report separately to the committee earlier.

Briefly, the staff found that the index-related trading was not very significant during the narrow time period in which the stock and futures markets peaked and began to fall rapidly. Furthermore, for the entire day, such trading was smaller in magnitude and relative to total volume than what was found on either September 11 or 12. Nor did the study find any evidence of manipulative activity within the futures market. None of the largest net traders during the key intraday periods examined appeared to have caused the price drop, nor to have been positioned to profit from it. The analysis indicates that the price drop on January 23 was most likely a correction to a very rapidly rising stock market. After that correction, the stock market rose to new record highs. We will continue our monitoring of these markets in coordination with the SEC to assess whether any additional regulatory measures are warranted.

With respect to some of the issues the Commission has been considering in the agricultural area, we have undertaken several initiatives in response to the controversy involving cattle futures trading that arose after last year's USDA Dairy Termination Program. We have cooperated fully with the GAO in its report on cattle futures trading, including conducting a "special call" to generate data on market composition not available through our normal large trader reporting system. We have initiated publication of monthly advisories to make available aggregate information on the composition of the live cattle futures market. We have also met with the National Cattlemen's Association Futures Task Force and other industry groups seeking to make cattle futures trading more responsive to the needs of a broader segment of the cattle industry. Also, the staff currently is reviewing and summarizing the extensive public comments we received in response to proposed rules to revise speculative position limits for agricultural commodities.

Mr. Chairman, that concludes my statement. My colleagues and I would be pleased to answer any questions you may have.

Thank you very much.

[The prepared statement of Ms. Phillips and the study, "A Review of Stock Index Futures Trading on January 23, 1987," follow:]

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[1] See page 28 for the study: A Review of Stock Index Futures Trading on January 23, 1987."

STATEMENT OF SUSAN M. PHILLIPS, CHAIRMAN
COMMODITY FUTURES TRADING COMMISSION

Mr. Chairman and Members of the Committee, I appreciate this opportunity to appear before you today. I expect that this is my last appearance before this Committee as Chairman of the Commodity Futures Trading Commission.

I plan to discuss in detail the issues that you specifically requested, including off-exchange instruments, the regulation of foreign futures and options and program trading. Since this is a general oversight hearing, I also would request your indulgence to outline pertinent aspects of other Commission programs, highlighting activities since the reauthorization hearings in February, 1986, and the Commission's progress in implementing the 1986 reauthorization legislation.

First though, before I begin, I want to tell you how much I have enjoyed working with this Committee the last several years. I have great respect for the work of this Committee and its staff particularly in overseeing the Commission in a constructive atmosphere. While the press may have reported that we did not always see eye-to-eye on certain issues, I think our points of view were not at cross purposes with respect to the public good, and, indeed, our first priority has been the public good. I believe the current regulatory environment for futures trading, fashioned and refined through the reauthorization process, speaks for itself. The industry regulated by the CFTC is vibrant and growing, and the Commission has active and complete regulatory, surveillance and enforcement programs to prevent manipulation, fraud and other trading abuses. I appreciate the time you have given to legislative and oversight initiatives, and I thank you for your interest in the Commission's activities.

As you know, the Commission has now spent more than 12 years effectuating its Congressional mandate. My fellow Commissioners and I believe the agency has matured into a responsible body since April, 1975, when it assumed the responsibility for the increasingly difficult and complex issues of regulating an expanding futures industry.

In 1973 and 1974, when the Congress was debating issues concerning the creation of an independent agency, it was this Committee that was instrumental in determining that futures trading must be governed by a uniform, national regulatory system no matter whether the specific underlying product was a farm good, a precious metal, an energy resource or a financial instrument.

The CFTC has followed this functional approach to its regulation of all futures trading, maintaining the consistency of the view Congress expressed in the Commodity Futures Trading Commission Act of 1974 that all futures provide the same economic services or functions. The same fundamental economic and legal standards are applied to futures contracts for all types of products, so that a single exchange can trade futures on grain and a stock index under the same regulatory structure. The economic purpose of futures trading as commercial hedging and price basing instruments remains the centerpiece of CFTC regulation.

Industry growth has been the result. Recent years have seen the rapid expansion of trading from agricultural commodities to entirely new markets. In fact, futures on foreign currencies, energy products, U.S. government securities and stock indices are

now the most heavily traded commodities. In addition, under the Commission's oversight, exchange-traded options on futures contracts and physical commodities are permanently available for hedging price risks.

Another key concept in the Commission's program is industry self-regulation. It is working, and particularly in the last few years, the exchanges have come a long way toward improving their market surveillance and rule enforcement programs. The National Futures Association (NFA) and the Commission have worked to refine registration standards, regulation of sales practices and audit programs of commodity professionals to ensure the high standards of commercial honor and just and equitable principles of trade in the conduct of their business that Congress has required under the Act.

Industry innovations are continuing apace. New trading instruments are facilitating international credit flows and expanding communication technologies facilitate operational and compliance improvements. Both are making international trading a reality. The Commission has had quite a challenge in keeping up with these innovations. Approving international trading links requires information sharing agreements between and among governments and self-regulatory bodies. Informal dialogues between government regulators are only the first steps toward more formal memoranda of understanding, such as the one recently signed by the Commission, the Securities and Exchange Commission (SEC) and the Department of Trade and Industry of the United Kingdom.

Through all of this, the Commodity Exchange Act (Act) has proved to be more than adequate to handle the new regulatory agenda of the Commission. Other countries have looked to the Act as the model in developing their commodity legislation. Early Commission reauthorizations resulted in significant changes to the Act as the Commission and the industry developed a regulatory environment. In recent years, that process has stabilized somewhat. In contrast to the significant changes in the law the Commission sought in 1982, the 1986 amendments were largely limited to an enhancement of enforcement powers that will permit better customer protections.

Implementation of the Futures Trading Act of 1986

The Commission generally has implemented the provisions of the Futures Trading Act of 1986 (1986 Act). The following is a report on that implementation and on the status of a few other issues that the Congress debated during the 1986 reauthorization.

Leverage Survey

After extensive debate as you know, the Congress directed the Commission to conduct a survey to identify the extent of interest of firms wishing to enter the leverage business and to transmit a report concerning the results of the survey and certain other matters back to you, our authorizing committee.

NFA mailed the survey questionnaire last month with a response deadline of August 15, 1987. NFA expects to tabulate and analyze the responses and prepare a report to the Commission on the results of the survey by November. At that time, the Commission will determine what, if any, amendments are needed to its leverage regulatory program and prepare appropriate rule proposals. By the November, 1988, statutory deadline, the Commission will submit its report to the Congress along with any recommendations to amend

existing leverage regulations. Three firms currently are licensed to conduct leverage business.

Ex Parte Appointment of Receiver

The Commission's new enforcement tool---the ex parte appointment of a temporary receiver---that Congress approved last year has been shown to be effective in protecting customers' interests when they become entangled in off-exchange fraud. The Commission's Division of Enforcement has used the authority three times since President Reagan signed the legislation into law.

This new authority has been used in conjunction with complaints alleging the unlawful and fraudulent sale of off-exchange futures contracts, when the Commission suspected that a firm's books and records might be removed and that customer funds might be dissipated.

Aggregation, Speculative Limits and the Definition of Hedging

During reauthorization last year, Congress urged the Commission to reexamine these three issues related to the administration of speculative limits in light of recent changes in the nature, size and composition of the futures and option markets. The Commission and its Advisory Committees moved quickly to address these questions.

On March 5, 1987, the Commission published proposed rules to amend current federal speculative position limits in agricultural futures contracts after significant comment on an advanced notice of proposed rulemaking. In general, these proposals maintain current speculative limits for the delivery months but increase levels for the deferred months. Certain reporting requirements would also be modified in line with these proposed revisions. These proposed rules have received a great deal of comment from interested parties. The Commission currently is studying these various comments and probably will be publishing final rules some time this year.

The Financial Products Advisory Committee, chaired by Commissioner Robert R. Davis, submitted its report on the definition of hedging to the Commission on June 5, 1987. The focus of the Committee's inquiry was on whether or not the existing definition encompasses all appropriate commercial and institutional uses of the financial futures and option markets introduced since 1977, when the definition was last amended. I understand that Commissioner Davis has forwarded copies of his Committee's report to this Committee and the House Agriculture Committee. Commission staff is now reviewing the report and will be making recommendations to the Commission on various aspects of the report.

Also, the Agricultural Advisory Committee, chaired by Commissioner Kalo A. Hineman, provided a means for obtaining views from the agribusiness community on these issues as well as disseminating information to the various interested groups.

Other 1986 Amendments or Report Language

The Congress passed several other amendments to the Act concerning the relationship between the Commission and the industry self-regulatory organization, NFA. One such amendment eliminated the automatic stay provisions relating to final disciplinary actions brought by a registered futures association against its members. Thus, an appeal to the Commission will not operate automatically to stay a disciplinary action unless the Commission so orders. The Commission is drafting regulations to codify its procedures for expedited consideration and determination of

the question of the entry of a stay in appropriate cases. In a related area, we have recently adopted revisions to our existing rules governing review of exchange disciplinary actions.

The Commission also has proposed rules for public comment that would exclude insurance companies from the definition of Commodity Trading Advisor (CTA) when their use of the markets is incidental to their insurance business and that would exempt from CTA registration certain investment advisers registered with the SEC. The comment period expired last week.

The Commission also published rules establishing guidelines for those transactions in actual commodities and in futures in which Commission members and employees now may engage.

Implementation of Exchange Audit Trail Improvements Nears Completion

In January, 1986, the Commission required the nation's commodity exchanges to improve their audit trails, or record of trading, by ascertaining the minute in which each trade occurs. Since that time, the exchange community has been taking the necessary steps to implement systems designed to comply with the one-minute standard. Beginning July 1, the exchanges' systems, with the exception of the Coffee, Sugar and Cocoa Exchange, which has until July 31, all had to be in place. By way of background, the Commission previously required that brokers and traders record only the 30-minute time period, or "bracket," in which a trade occurred. By requiring a one-minute trade timing standard, the systems contemplated by the new rule will increase significantly the precision of the times associated with trades. As a result, the ability of the Commission and exchange compliance officials to detect and prosecute suspected trading abuses will improve materially. The Commission believes that an improved audit trail also will act as a deterrent to trading rule violations and as a means by which trade disputes may be resolved.

The Commission's audit trail rule has permitted the exchanges to choose the method of their compliance. Some exchanges simply are requiring their members to write down the minute they execute the trade when they record other trade information, such as price and quantity. On other exchanges, an exchange employee time-stamps the minute of execution on trading cards immediately after the broker or trader records essential trade information. Still other systems use trade data, such as manually-recorded times for certain trades, the time-stamped minute on order tickets for trades involving customers, and the exchange's record of price changes (recorded in 10-second intervals or less). These data are then combined in a series of computer matches to determine the execution time for all trades within one minute.

The Commission has begun conducting compliance reviews of the exchange audit trail systems to ensure that each exchange is meeting the one-minute standard and also is complying with other audit trail requirements, such as the requirements that customer order tickets be timestamped. Two of these audit trail reviews will be completed by the end of fiscal year 1987, and the staff has set a goal of completing a review of each exchange by the end of calendar year 1988. Some of these reviews will focus solely on audit trail matters, and others will be part of regularly scheduled oversight reviews of exchange self-regulatory programs. In addition to examining whether exchanges are meeting the one-minute standard, these reviews also will determine whether the improved

audit trail data have been integrated into exchange compliance systems and whether the improved data are used in exchange disciplinary matters. As in the case of regular oversight reviews of exchange compliance programs, the audit trail review reports will make recommendations for improvement where necessary.

Now, Mr. Chairman, I will address the issues that you requested I outline for the Committee: off-exchange issues, foreign futures and option rules, and program trading.

Off-Exchange Issues

Paralleling the rapid growth of domestic futures markets has been a growing interest in new forms of off-exchange commodity and commodity-related instruments. The centerpiece of the Act's regulatory scheme calls for futures contracts to be traded on exchanges, subject to vigorous self-regulation and oversight by the Commission. As this Committee is aware, however, the Act does provide for certain exceptions to the general requirement of exchange trading. Specifically, the Act or Commission regulations contain the "cash forward" contract exclusion, the "Treasury Amendment," dealer and trade option exemptions and leverage. Apart from leverage and dealer options, these exemptions have been aimed at accommodating traditional, commercial cash market transactions, where delivery of the commodity is common.

In the last two years, the Commission has had to confront a wide variety of innovative and sophisticated over-the-counter instruments that have characteristics similar, or identical, to those of exchange-traded futures and options. These new products are said to offer highly customized terms, operational efficiencies and potentially lower transactions costs and greater profitability than exchange-traded contracts.

The Commission finds itself under increased pressure to engage in virtually instant analysis of the legality of these new products. Frequently, we are not notified of the issuance of these instruments until shortly before or after they are offered and sold. To date, the Commission has not been inclined to hinder the introduction of these instruments except in those instances where they clearly are illegal, off-exchange contracts.

Because of the complexity and novelty of the issues presented by some of these new instruments, the Commission has established an internal staff task force to examine over-the-counter risk management instruments and to recommend a general framework within which the Commission can address these new instruments and markets. The task force is now directing its attention to several specific areas as discussed in the Commission's June 9, 1987, public meeting.

The first area relates to a June, 1986, no-action letter issued by the Commission's General Counsel stating that it would not recommend enforcement action where an export trading company proposed to offer an off-exchange hedging service via a "financial credit arrangement" to other commercial entities engaged in export or international trade. The staff's position was based on Congressional policy to encourage the export of domestic commodities set forth in the Export Trading Company Act and on the fact that the arrangements were to be subject to Federal Reserve Board approval. We understand that such approval is presently being sought, and Commission staff are in contact with Board staff on this issue.

Another developing off-exchange activity is bank-financed precious metals programs. In August, 1985, the Commission's

General Counsel issued an interpretative letter on this subject, as well. Under the program in question, a dealer sells a physical commodity, a precious metal to a customer. The customer pays 20% of the purchase price and a bank, pursuant to a separate loan agreement with the customer, pays the remaining 80% of the purchase price. Within seven days, title to the metal, which is in the possession of the bank, passes to the customer. The bank holds a lien on the metal as the collateral on the loan. The customer could be subject to demands from the bank for additional funds if the value of the metal declines. Because title passes immediately, the transaction lacked the element of futurity. The staff letter determined that it is not a futures contract. In addition, because the transaction was for a term of less than 10 years, the letter determined that it did not meet the Commission's definition of a leverage contract. Therefore, the letter concluded that these transactions were not within the Commission's regulatory jurisdiction. The North American Securities Administrators' Association (NASAA) has recently requested that the Commission consider withdrawing this interpretative letter because of concern over possible abusive practices. This question and the policy considerations implicated by bank-financed precious metals programs are under consideration by the task force.

Foreign currency trading is another type of over-the-counter trading, which has been somewhat controversial due to varying interpretations of the Treasury Amendment. In an October, 1985, Federal Register release, the Commission interpreted this Amendment to exclude from its jurisdiction futures-type foreign currency transactions when conducted between banks and other sophisticated, informed institutions, but not when the transactions were marketed to members of the general public. The release invited comment on the composition and level of expertise of the participants in the foreign currency interbank market. Because the comments received indicated widely divergent views on the scope and intent of the Treasury Amendment, the Commission's task force is taking a second look at these questions.

Another area of increasing off-exchange commercial trading is hybrid debt-option instruments used to raise capital through public securities issues. These generally take the form of a debt offering that pays a variable rate of return (perhaps with a guaranteed minimum rate) that is "indexed" to changes in the price of a specified commodity above a certain level over the term of the instrument. Commodity price changes may be calculated by reference to a widely disseminated cash price or to the price of an exchange-traded futures contract. The investor's ultimate rate of return depends in part on the movement of the commodity price above a certain fixed level between the issue date and a set future date.

These hybrid instruments have in the past been indexed to the price of crude oil and precious metals. Several months ago, however, the Commission learned of the issuance of a new type of hybrid instrument tied to the exchange rate between the dollar and specified foreign currencies. These so-called principal exchange rate-linked (PERL) debt securities are issued at par, pay interest on the face value until maturity, and repay a variable principal in dollars. The amount of the principal repayment is tied to the exchange rate between the dollar and a foreign currency at the maturity of the note, and the ultimate return of principal can

range from zero to a multiple of the original principal lent by the investor.

The Commission's responsibility over these hybrid instruments turns largely upon whether they are determined, on a case-by-case basis, to be futures or option contracts. More often than not these instruments contain elements of options, forward contracts and futures, but do not fit neatly into any of these categories.

In addition to our study of these difficult regulatory questions, the Commission has devoted significant staff resources to policing the sale of clearly prohibited off-exchange activities in retail futures and option products, many of which are associated with fraudulent commodity operations. In the past three years, the Commission's Division of Enforcement has brought over 25 injunctive proceedings alleging the illegal sale of such contracts. Several of these actions were brought jointly with the states, including Arizona, Texas, Missouri, Florida, New Jersey and California. The Division's State-Federal Liaison Unit also has conducted seminars for state law enforcement authorities on how to develop a case against unlawful off-exchange operators. The Commission also has worked closely with NASAA in its efforts to have the states enact the Model State Commodity Code.

In conclusion, the development of new forms of off-exchange commodity and commodity-related instruments presents significant challenges to the futures industry and to the Commission. We have undertaken to study the complex issues raised in this developing area. The staff task force provided the Commission with a preliminary draft outline of the questions it proposed to examine and the Commission held a public meeting on June 9 to discuss the outline and give the staff direction on how to proceed with various aspects of the study. We will continue our examination of these transactions and, if appropriate, will undertake regulatory initiatives or make legislative recommendations to Congress in the future. We will keep the Committee apprised as the work of our task force progresses.

Foreign Futures and Options

As the Committee is aware, presently pending before the Commission are proposed rules to govern the offer and sale of foreign futures and option contracts in the United States. The adoption of final rules in this regard will conclude the several regulatory initiatives that resulted from the Commission's reauthorization in 1982. Because these proposed rules have become a matter of particular interest to members of this Committee as well as other members of Congress, it may be useful to review the development of these regulations to date.

Today, foreign futures may be sold in the U.S. free of any regulation. Foreign options, on the other hand, are banned generally, although there is a commercial exemption for option purchasers.

As the Committee will recall, in connection with its reauthorization in 1982, the Commission requested, and Congress adopted, an amendment to the Act reaffirming the Commission's existing authority to regulate the domestic offer and sale of foreign futures. It is important to note that this authority was directed at protecting U.S. customers from fraud in connection with the sale of foreign products. The Commission did not seek, nor did Congress grant, authority to interfere in any way with the operation of a foreign futures exchange. To the contrary, section 4(b)

enacted in 1982 specifically prohibits the Commission, in the exercise of its authority, from requiring Commission approval of any contract, contract terms, rules or actions of a foreign board of trade, market or clearinghouse.

On July 25, 1984, the Commission published in the Federal Register an advance notice of proposed rulemaking raising a series of issues relevant to the potential regulation of the offer and sale of foreign futures in the U.S. In the advance notice, the Commission sought public comment to assist in determining the need for a more formal regulatory program with respect to such activities in the U.S. In addition, the Commission requested comment on, among other issues, the extent to which a regulatory structure developed for foreign futures transactions could serve as a model for the regulation of foreign exchange-traded commodity options in the U.S. At the request of members of the domestic futures industry, the original 60-day comment period was extended an additional 45 days.

On April 8, 1986, following detailed consideration of the comments received and significant debate within the Commission on the appropriate scope of any rules, the Commission published a notice of proposed rulemaking on the regulation of foreign futures and option contracts in the U.S. The development of this proposal presented the Commission with the difficult task of balancing a number of apparently competing goals. For example, although foreign options had been banned since 1978, foreign futures had been traded in an essentially unregulated environment -- except for the Commission's antifraud rule -- during the same period. The Commission, therefore, wanted to create a program that would provide adequate protection against the types of customer abuses that led to the options ban, without interfering unnecessarily with existing commercial relationships in the foreign futures markets. In this same regard, the Commission was aware of the inherent limitations of providing protection to U.S. residents who elect to trade on foreign exchanges outside the Commission's jurisdiction and was concerned that it not promise more than it could deliver.

With respect to those entities physically located offshore, the Commission wanted to ensure that they would be subject to regulation which would be comparable to that governing firms located in the U.S., both to ensure the fitness of such entities and to create a "level playing field" so that firms would not be encouraged to move offshore. At the same time, the Commission did not want to impose a duplicative regulatory scheme on foreign firms that might be subject to comparable regulation by authorities in their own countries. Assuming appropriate agreements for the sharing of information could be entered into, a duplicative regulatory scheme would serve no additional regulatory purpose. Finally, the Commission did not want to impose any additional, unnecessary regulatory obligations on its current registrants.

To achieve these goals, the Commission proposed rules that, to the extent possible, parallel the rules governing the offer and sale of domestic futures and options. Thus, registration, disclosure and segregation of customer funds are the essence of the proposed rules. There are two major exceptions from the Commission's current rules. First, the rules exclude from the definition of "customer" the so-called "commercial customer". Second, the rules contemplate that the Commission may grant exemptions

from some or all of its regulations to those firms located in foreign countries that are subject to comparable rules.

The Commission believed that this exemptive authority would be consistent with the guidance offered by this Committee and the House of Representatives Committee on Agriculture in the reports accompanying the 1982 legislation. In this connection, this Committee noted that the Commission would be authorized under section 4(b) "to develop different requirements for vendors [of foreign products] depending upon the particular board of trade or market on which the foreign futures contracts are made, in particular, taking into account those foreign futures contracts that have not traditionally posed a danger to U.S. residents." Further, the Commission was advised that it should "take into account the customs and practices of foreign boards of trade or markets and recognize that differences may exist between the practices of foreign boards of trade and their U.S. counterparts." Finally, the Committee cautioned that any regulations that may be developed were not "to place the solicitation or acceptance of orders in the U.S. for bona fide foreign futures contracts at a comparative disadvantage with similar solicitation or acceptance of orders for domestic futures contracts."

Because of the diversity among the foreign exchanges noted by the Committee, the Commission believed that it would be impossible to deal with these matters without devising rules so complex as to be incomprehensible. Therefore, the Commission concluded that it would be preferable to deal with these matters on a case-by-case exemptive basis.

The Commission received 30 comment letters, representing U.S. contract markets, FCMs, the Futures Industry Association, NFA, U.S. Government agencies, and 13 foreign commenters. The foreign commenters included exchanges, commodities firms, one of which is also a registered FCM, and five foreign governmental entities. The comments were by no means uniform, and, as you might expect, each commenter represented its own self-interest.

Generally, the U.S. contract markets supported the development of the regulatory framework for the offer and sale of foreign futures and option transactions but expressed the view that the system should be equivalent to the regulatory framework for domestic futures and option transactions. In view of the development of virtually identical instruments abroad and the fact that international competition for U.S. customer funds has intensified, the exchanges expressed concern that, in the absence of parallel regulation for both foreign and domestic transactions, the ability of U.S. exchanges to compete with their foreign counterparts may be undermined. The treatment of certain "commercial" persons under the proposed rules was particularly distressing to the exchanges, which noted that if, as the Commission stated, these commercial entities do not need the special protections with respect to trading on foreign exchanges, the need for such protections is even less compelling when they transact business on U.S. exchanges, which are subject to strict surveillance by U.S. regulators.

The FCM community in the U.S. was generally of the opinion that, at the present time, it is unnecessary for the Commission to create an elaborate scheme for the regulation of foreign futures and option transactions. Several FCMs urged the Commission to limit its exercise of authority over foreign futures and options

to the registration requirement and the antifraud provision. The majority of the FCMs also recommended that the definition of "commercial" persons be broadened to include institutional users of the commodities markets and financial entities. More important, however, the FCMs objected to the proposed requirement for the separate segregation of foreign futures and option customer funds, which they believe will be difficult to implement and which they contend their current computer systems may not be able to accommodate.

NFA commented that U.S. participants in foreign futures and option transactions should be afforded protections substantially similar to those afforded customers whose transactions are executed on domestic exchanges. Therefore, while the Commission should promulgate rules governing registration and minimum financial requirements for firms engaged in foreign futures and option transactions, maximum flexibility would be achieved if the Commission permitted additional requirements in areas such as segregation, recordkeeping, disclosure and sales practices to be imposed through NFA rulemaking.

Many of the foreign commenters expressed concern that the Commission's proposed rules governing foreign futures and option transactions will have a discriminatory and anti-competitive effect on the commodities markets in their respective nations and would place them at an unfair competitive disadvantage with U.S. markets. Certain foreign commenters also stated the view that the Commission has no jurisdiction to promulgate rules governing persons with no physical presence in the U.S. However, the foreign commenters uniformly supported the availability of the exemptive procedure in the proposed rules and expressed the opinion that the regulatory systems in place in their respective countries provide protections comparable to those existing in the U.S. Accordingly, should the Commission adopt the regulatory system as proposed, they commented that they should be exempted from the application of the rules.

As the Committee can no doubt appreciate, responding to these diverse comments is by no means an easy task. In this connection, therefore, following the end of the formal comment period, the Commission and its staff have continued to meet with interested parties in order to understand more completely their concerns and to explore various alternatives with them. As a result of this process, the Commission staff has prepared a recommendation with respect to amendments to the proposed rules that the Commission will consider at a public meeting next week, July 23. These amendments will address those issues of primary concern to the commenters -- capital adequacy, protection of customer funds and the commercial exception -- yet are consistent with the Commission's responsiblities under the Act.

In conclusion, let me assure the Committee that the Commission is committed to the adoption of regulations governing the offer and sale of foreign options and futures. In view of the increasing internationalization of the markets, the Commission believes it is imperative that regulations be put into place now in order to assure adequate protection of U.S. customers. These regulations also are intended to prevent the recurrence of the types of scams that had occurred prior to the establishment of the Commission and institution of the options ban. Such regulations also will provide a vehicle through which the Commission can work with

regulators in other countries to harmonize different regulatory structures. At the same time, however, the Commission is conscious of the complexity of this issue and will monitor all regulations adopted, amending them as experience dictates.

Stock Index Futures Activity

Another area to which the Commission has devoted considerable attention in the past year has been the interaction between stock index futures markets and the underlying securities markets. Much public attention and regulatory effort has been focused on the issues of whether certain uses of stock index futures and options such as program trading have contributed to increased price volatility in the securities markets and whether additional regulatory measures are warranted.

Broadly defined, program trading is a stock market trading technique that actually predates the inception of stock index futures and option markets. Program trading generally is characterized by institutional sales or purchases, which are often computer aided, of large baskets of stocks. A subset of such trading activities is the purchase or sale of a basket of stocks based on computer-identified price discrepancies between stock index futures or option contracts and their theoretic or fair market value (a function of individual stock values, carrying costs, stock dividend yields and transactions costs) relative to the current market value of the indices underlying these contracts. Such "stock index arbitrage" involves the purchase (sale) and the sale (purchase) of stock index futures or options when the latter are overpriced (underpriced) relative to the stocks that make up the index. As a result of such arbitrage, misalignments between derivative and stock market prices are reduced or eliminated, and hedging is thereby facilitated.

The principal derivative instrument used for these types of sophisticated trading strategies is the S&P 500 stock index futures contract of the Chicago Mercantile Exchange (CME). In addition to being the largest stock index futures market, that contract also is one of the most actively traded futures in the industry. It is heavily used by traditional securities industry participants, such as broker-dealers, investment bankers, pension funds, insurance companies and other securities portfolio managers for hedging or risk shifting, asset allocation, arbitrage and other forms of risk management.

When unwinding hedged positions at expiration, it is critical to arbitrageurs to obtain the opening or closing price for the baskets of stocks they buy or sell when the futures and option contracts are settled on the opening or closing prices of each stock in the index. Thus, when the expiration of a stock index futures contract requires large arbitrage positions to be liquidated, large orders are brought to the stock market with the potential of creating imbalances between investors' buying and selling, which may result in stock price volatility.

Consequently, much of the attention to "program trading" has centered on the so-called "third Fridays" or "triple witching days," when there are contemporaneous expirations of the major stock index futures and option contracts, as well as stock options. These expirations occur on the third Friday of March, June, September and December. Empirical analyses suggest that the prices of certain stocks that figure prominently in arbitrage baskets have become more volatile and perhaps have deviated temporarily

from equilibrium levels near the quarterly expirations of stock index futures and option contracts. When stock prices have moved sharply in one direction near the close of the market on an expiration Friday, these prices have tended to move rather quickly in the opposite direction on the following Monday morning. In most of these situations a number of large, arbitrage-related stock orders were submitted to the New York Stock Exchange (NYSE) floor near the market's close on expiration Fridays.

Since the futures and option markets have proved to be so valuable to the securities industry, the Commission has worked closely with the SEC and with futures and securities exchanges to examine and develop appropriate, coordinated regulatory responses to these perceived problems. We believe these joint endeavors have been productive, and the level of cooperation and coordination among the securities and futures regulators has been excellent.

Both agencies consistently have sought regulatory responses to concerns about the derivative markets that would not unduly impair their economic utility. Accordingly, our responses to date have been in the areas of providing better surveillance information to all the affected regulatory and self-regulatory interests, providing information to the public and the investment community about the exact nature of these market interactions, and fostering certain changes in securities and futures market trading practices or contract design to minimize the potential impact of stock index expirations. These coordinated efforts appear to have had a beneficial effect thus far. However, we will continue to monitor these markets carefully.

One of the first steps taken was to assure that the regulatory and self-regulatory authorities were cooperating in the exchange of surveillance information regarding these markets. The CFTC has been sharing large trader data from our surveillance system with SEC staff for some time. The securities industry's Intermarket Surveillance Group has proven to be an effective vehicle for extending this information sharing so that securities and futures exchanges can assess more completely any position imbalances in the various option and futures markets as an expiration date approaches. The securities and futures exchanges also have worked together in joint reviews of unusual market activities. While this arrangement has worked satisfactorily, we expect a more formal inclusion of the affected futures exchanges within the Intermarket Surveillance Group to be arranged to solidify this coordinated surveillance approach.

The SEC and the NYSE also have taken steps to reduce the potential for disorderly markets by publicly announcing the size and direction of order imbalances in the 50 actively-traded stocks in the S&P 500 index. The publication of these order imbalances encourages other securities traders to enter orders on the opposite side of those imbalances, thereby helping to alleviate the price effect of large market-on-close orders. Variations of this practice have been utilized in each of the past four quarterly expirations.

The June, 1987, expiration was of particular interest because it was the first expiration following the introduction of a very significant contract modification. The CME amended the terms of its S&P 500 futures contract (and the option on the futures) to terminate trading on the Thursday afternoon preceding the third

Friday of the month and to settle any remaining open contracts based on the opening price quotations the following day on the NYSE. This change was based in large part on the belief of the NYSE and others that the NYSE's opening procedures were more suited to accommodating order imbalances with minimal price impact than were its closing procedures. Briefly, prior to the open, NYSE specialists can disseminate information about order imbalances to attract orders on the opposite side. They can also delay the opening when unusually large imbalances exist to permit more time for the submission of offsetting orders. The NYSE adopted additional procedures for the June 19 opening to provide earlier and broader public dissemination of any order imbalances. This last quarterly index product expiration proceeded very smoothly despite significant open interest going into the close. There were no significant price moves in the futures, options or securities markets on the June 18 close nor on the open or close of the stock market on June 19.

As the Committee is aware, the CFTC and the SEC also have conducted several special studies to determine whether activity in derivative markets was a significant cause of unusual price movements on certain nonexpiration days in the stock market. The SEC's report of trading on September 11-12, 1986 -- when the Dow Jones Industrial Average dropped 120 points -- was published in March of this year. CFTC staff participated in interviews and provided futures data and other assistance to the SEC in the preparation of that report. That report found that although there was substantial index-related trading on those days, the market-wide price decline apparently was a result of changes in investors' perceptions of fundamental economic conditions, rather than artificial forces related to index-related trading strategies. Nevertheless, index-related strategies may have condensed the period of time in which information as to these changed investor perceptions were translated into individual stock prices.

Commission staff recently completed an in-depth study of trading activity on January 23, 1987, a day on which the Dow Jones Industrial Average fell about 115 points in approximately 70 minutes. Our staff particularly analyzed trading in the CME's S&P 500 index futures contract to measure the extent to which index-related trading contributed to that price collapse and whether there was any indication of price manipulation within the futures market. Separately, I have provided a copy of this report to the Committee.

Very briefly, we found that index-related trading was not very significant during the narrow time period during which the stock and futures markets peaked and began to fall rapidly. Furthermore, for the entire day, such trading was smaller in magnitude relative to total volume than what was found on either September 11 or 12. Nor did the study find any evidence of manipulative activity within the futures market. None of the largest net traders during the key intra-day periods examined appeared to have caused the price drop nor to have positioned itself to profit from it. The analysis indicates that the price drop on January 23 was most likely a correction to a very rapidly rising stock market. After that correction, the stock market rose to new record highs.

In summary, the Commission and the relevant futures exchanges have devoted considerable resources to monitoring and analyzing the interactions between stock index futures and the underlying

securities market. This effort has yielded certain modifications of contract terms, trading practices and operational procedures to mitigate any price volatility in the securities market that may be related to derivative product expirations. This effort also has fostered an excellent working relationship between our staff and the staff of the SEC and among securities and futures exchanges. We will continue our coordinated monitoring of these markets to assess whether any additional regulatory measures are warranted.

Mr. Chairman, that concludes my prepared testimony. Thank you very much for this opportunity to appear before you this morning. I would be happy to answer any questions you or the Members of the Committee may have.

A Review of Stock Index Futures Trading on January 23, 1987

Prepared by:

The Division of Economic Analysis
Commodity Futures Trading Commission

July 1987

Findings and Conclusions

From January 2 through January 22, 1987, stock prices moved sharply higher, including many record-high values for popular indices, a record number of days of consecutively higher closes in the Dow Jones Industrial Average (the Dow), and culminating with a record 1-day gain in the Dow on January 22. On January 23, absent any significant economic news, stocks again moved sharply higher but then plummeted, yielding a record intraday swing of 115 points in the Dow on record volume. In response to concerns expressed by the Commission and by some in the securities industry and the Congress, the Division of Economic Analysis (the Division) examined trading activity for January 23.

The Division focused on concerns that trading strategies involving both stock portfolios and stock index futures may have caused or contributed to the record price drop that day. The Division also investigated whether, as a few have alleged, manipulative activity solely within the futures market might have pushed the prices sharply lower.

Since no individuals or firms were suggested to be responsible for the price reversal, the Division examined market-wide data to determine whether any participants were involved in abusive activities. This review focused specifically on trading in the Standard & Poors 500 (S&P 500) index futures, the derivative instrument most often used for stock index arbitrage. The

Division began with the most aggregate types of data on trading activity and successively analyzed more detailed data, finally examining the trading activities and trade prices for individual futures accounts during several brief time intervals that contained the most significant price movements.

The Division initially analyzed aggregate trading activity, by New York Stock Exchange (NYSE) member firms in stocks and by Chicago Mercantile Exchange (CME) member firms in futures, on the basis of largest gross trades, largest net buys, and largest net sales, both for January 23 as a whole and for selected time periods that day. These data for both stocks and futures show relatively balanced trading among the largest member firms. The few firms doing the largest buying on either exchange were also doing the largest selling. Moreover, those firms were generally doing the majority of their trading before prices peaked and began the sharp reversal.

The largest NYSE member firms had net buying or selling of only about 3 to 4 million shares compared to total NYSE volume of about 311 million shares. The data show that they did most of their trading early in the day before the extreme price volatility began. The firm with the largest net selling of stocks during the period when the sharp price break in stock prices began had gross sales of 1.4 million shares and net sales of 1.0 million shares compared to NYSE volume of 50 million shares during that period.

The CME member firms with the largest net buying or selling of S&P 500 futures included some firms who are also NYSE members. The aggregate trading of the CME firms with the largest net futures buying does not appear to be related to the price drop on January 23. Moreover, the limited data on stock traders made available to the Commission showed that the proprietary accounts of these largest net buyers of futures were not engaged in large offsetting sales of stocks. The extent to which large customers were buying futures and selling stocks is examined below.

A review of the aggregate trading of the CME firms with the largest net selling does not reveal any that were large enough individually relative to the volume during the day as a whole or during the sharp price drop to have caused the move. Since the trading by aggregate proprietary or customers' accounts through a particular brokerage firm may either offset or obscure the separate trading of large individual accounts, the Division next examined the futures trading activities for individual traders.

There were 43 traders that were net buyers or net sellers of 200 or more March 1987 S&P 500 futures contracts. Based on detailed trading data and interviews, the Division found that none of largest individual net buyers of futures caused, or positioned themselves to take advantage of, the sharp downward futures price move on January 23. Also of concern, however, was the extent to which their buying of futures might have been connected with the selling of stocks and, therefore, had a depressing effect on

prices in that market. Only one of the several largest net buyers of futures is generally involved in stock/futures arbitrage activity. Their trading activity indicates that their largest net buying of futures (and potential selling of stocks) amounted to only several hundred futures contracts (equal to less than 1.5 million shares) and occurred well after the sharp price drop began.

Based on the review of trading by the six largest individual net sellers of futures, the Division found that four were mostly liquidating existing long futures positions, thereby having nothing to gain from a downward price move. The other two increased existing short futures positions, but generally did so either before the sharp break in prices or gradually throughout the day. Moreover, to whatever extent these large net sellers of futures were involved in offsetting activity in stocks, they would have been buying stocks and therefore not causing or benefiting from falling prices in that market.

The Division also selected from the 43 individual buyers and sellers of futures all those normally associated with "program trading" or "portfolio insurance" to determine their potential aggregate impact on prices. (These trading strategies, which are more fully defined in the report, generally involve an automatic or programmed reaction to changing values between futures prices and stock indices.)

The review indicated that a significant number of the 43 individual traders were institutional users likely to be involved in those types of programmed trading strategies on January 23. Nevertheless, the potential quantities of stocks traded in connection with these strategies was small relative to total volumes of stocks traded that day and small relative to the proportion of this type of trading observed on other days of large stock price volatility. Furthermore, most of this type of trading was done either in the morning while prices were rising or later in the day after the market had reversed its course.

In the final portion of this report, the Division looks at intraday futures trading activity. First, trading during two half-hour time periods was examined. One of these intervals included the time when prices hit their highs and turned sharply lower. The other included the steepest drop in prices to their lowest levels of the day. These two half-hour intervals were then further divided into several segments for additional review.

Based on this analysis, which was restricted by some inaccuracies in timed futures transaction data and the lack of timed stock transaction data, the Division was able to draw two general conclusions. First, no traders appear to have traded futures in sufficient quantities or in a manner to have caused the initial sharp break in futures prices in the early afternoon on January 23. Second, nearly an hour after the initial break but just before the steepest portion of the price decline, weak futures

prices relative to underlying index quotes apparently induced some institutional traders to unwind existing short-futures/ long-stocks arbitrage positions. The quantities of futures bought in this regard would have tended to counter the down move in prices in that market, and the associated selling in stocks does not appear to be large enough relative to volumes in that market to have caused the sharp price drops that followed.

In summary, based on this review of the data and many trade interviews concerning events on January 23, the Division found no evidence of manipulation and no firm or individual trader that might have caused the sharp price swing that day. Institutional traders that traded in both stocks and futures in reaction to sharp changes in their relative values also were not the cause of the break in prices that day. There was no consensus among the traders concerning what did cause the sharp drop in prices. Several traders commented that some of the stock price volatility that day was due to the inability of the stock specialists to maintain an orderly market during periods of heavy volume and the lack of sufficient liquidity in the futures market to absorb the large, widespread selling that suddenly developed.

Whatever the cause of the intraday volatility on January 23, the closing values that day were affirmed by the following day's trading, which saw prices trade in a small range on either side of the close on January 23 and end with a small gain. The market subsequently trended higher and, within a few weeks, exceeded the highest level it had reached on January 23.

A Review of Stock Index Futures Trading on January 23, 1987

INTRODUCTION

January 23, 1987 was a day that attracted a great deal of attention in financial markets due to a sharp intraday swing in the popularly quoted stock averages accompanied by record volume on the New York Stock Exchange (NYSE). The Dow Jones Industrial Average (the Dow) on January 23 closed down 44.15 points, or 2.06 percent below the prior day's close. That was one of the largest declines in the Dow based on absolute value, although it was much less significant on a percentage basis. (See Attachment 1) At the same time, two other widely quoted stock indices--the S&P 500 Stock Index (S&P 500) and Value Line Average (VLA)--declined 3.81 points or 1.39 percent and 2.25 points or .90 percent, respectively. The most striking aspect of price activity that day, however, was a 115-point swing in the Dow in about 70 minutes during the early afternoon.

In reaction to the precipitous drop in stock index prices on January 23, public policy questions once again were raised by individuals in the securities industry, in the Congress, and at regulatory agencies. These questions have focused on the extent to which trading strategies involving both stock portfolios and

stock index futures or options may accentuate price volatility in the stock market. 1/

Commentators have questioned whether index arbitrage, one form of "program trading" in which stock portfolios are sold on the New York Stock Exchange and stock index futures simultaneously are purchased, may have been a principal cause of the price drop on January 23. Questions also have arisen whether "portfolio insurance" activity, in which institutional investors sell stock index futures to reduce the equity exposure of their portfolios when the stock market declines, may also have been a contributing factor. Some have even questioned whether other activity initiated solely within the futures market--perhaps with a manipulative intent--may have caused the large, simultaneous price declines that occurred in both futures and stock markets.

This latter allegation should be considered within the context of the different trading environments of futures and stocks. Specifically the largest stock index futures market usually is more liquid than the market for individual stocks on the NYSE and, therefore, generally is less susceptible to sustained price

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1/ See also the study by Hans Stoll and Robert Whaley, "Expiration Day Effects of Index Options and Futures," March 1986, and the recent study by the Division of Market Regulation of the Securities and Exchange Commission (SEC), "The Role of Index-Related Trading in the Market Decline on September 11 and 12, 1986," March 1987, which previously dealt with these same issues.

aberrations caused by a sudden burst of selling or buying, particularly on high volume days such as January 23. Nevertheless, it has been alleged that during a period of relative illiquidity or market uncertainty--when major participants temporarily have withdrawn from the market--some trader or traders may be able to "move" the futures price enough to start a sustained price movement. Hypothetically, such a movement could develop if, for example, selling in the futures market caused the initiation of arbitrage "sell programs" (selling stocks and buying relatively underpriced futures). It has been argued that such sell programs in the stock market would lead to further declines in futures prices, permitting the traders who started the process to cover their short futures positions at a profit.

In this study, the Division has analyzed futures market activity on January 23 to assess the extent to which "program trading" or "portfolio insurance" may have been significant contributors to the large price drop that occurred that day. Intraday futures trading also was analyzed to determine whether there was any evidence of manipulative activity.

I. BACKGROUND

The prices of derivative stock index products closely parallel the movements in prices of stocks and stock indices. These derivatives include options on specific stocks, options on stock indices (the most actively traded of which is the Chicago Board

Options Exchange's option on the S&P 100 index (OEX)), stock index futures, and options on those futures. The most active of these latter two are the Chicago Mercantile Exchange's (CME) S&P 500 future and its option. 2/

Prices of stock index futures are a function of the value of the underlying stocks in the index, the carrying costs, time to expiration, stock dividend yields, and transaction costs. 3/ These factors can be used to calculate an index product's "fair market value" relative to the current market value of the underlying stocks. Whenever the actual value of an index product trades at a significant premium or discount to its fair market value, arbitrage opportunities exist.

Index arbitrage of price disparities between baskets of stocks and derivative stock index products is most common between stock index futures and a representative basket of stocks that replicates the underlying ("cash") index. Also, the most heavily traded stock index future is the S&P 500 future. Throughout the first quarter of 1987, the fair value of the S&P 500 future was

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2/ On January 22, 1987, open interest in the stock index futures was as follows: S&P 500 future--113,808 contracts (of which 109,163 was in the March 1987 contract); Value Line Index on the Kansas City Board of Trade--11,014 contracts; NYSE Composite Index on the New York Futures Exchange--13,399 contracts; and the Major Market Index on the Chicago Board of Trade--6,626 contracts.

3/ The value of an option also is related to the volatility of the underlying index and the option strike price.

generally within ±0.8 percent of the actual value of the index. (Attachment 2) This narrow band implies an efficient index/futures relationship where opportunities for arbitrage exist only for brief periods. Nevertheless, substantial arbitrage activity is conducted by a large number of investment bankers, pension funds, and securities dealers.

As depicted in Table 1 below and the graph in Figure A, beginning Monday, December 22, 1986, the first business day after the so-called "triple witching day," 4/ through December 31, 1986, the Dow Jones Industrials Average declined approximately 33 points or 2 percent. Other major indices and derivative products moved in similar fashion. These declines generally were attributed in the popular and financial press to higher than normal yearend tax selling brought on by the Tax Reform Act of 1986, which changed the future tax treatment of capital gains.

4/ These are quarterly Friday dates when stock index futures, stock index options, and individual stock options expire simultaneously. The index products are cash settled to the closing value of their respective indices. Beginning with the June 1987 expiration, however, the S&P 500 future and option expires a day prior to some of the other derivative markets.

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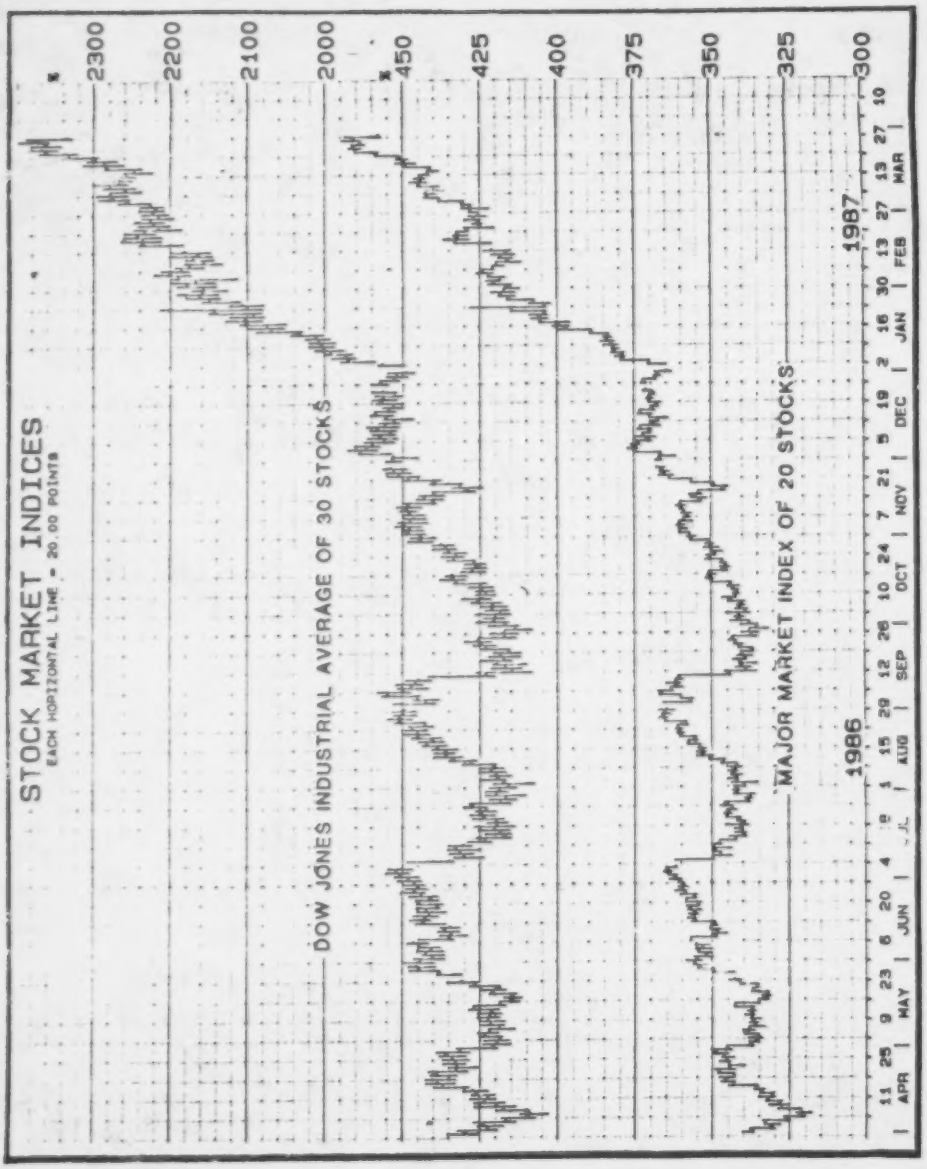
Figure A



SOURCE: COMMODITY RESEARCH BUREAU

Table 1

Changes in Cash Indices and Derivative Products

Index/Market	Net Change 12/22 through 12/31		Net Change 1/2 through 1/22	
	Points	%	Points	%
Dow index	-33	-2	250	+13
S&P 500 index	-8	-3	32	+13
VLA index	-5	-2	24	+11
S&P 100 index	-7	-3	32	+14
Feb. 1987 MMI future	-6	-2	52	+14
Mar. 1987 S&P 500 future	-7	-3	34	+14
Mar. 1987 VLA future	-5	-2	26	+12

As the new year arrived, the stock market reversed course and began moving sharply higher. From January 2 through January 22, 1987, for example, the Dow gained approximately 250 points (13 percent). These gains took place in just 15 trading sessions, which included a record 13 successive days of record-high closing values of the Dow.

Widely circulated theories given for these advances were: institutional traders had large cash reserves after the yearend selloff and were looking to reinvest; declining interest rates induced movement from competing securities to stocks; and corporate earnings were expected to improve given low inflation, cost cutting, and mergers. Lastly, although the declining dollar was viewed as a crosscurrent, the market appeared to focus on the prospect that the declining dollar would boost the earnings of companies that do business overseas or compete with foreign firms in this country.

On January 22, 1987, the Dow closed at 2,145.67, up 51.60 points for the day. At the time, that was the largest one-day gain in the Dow and a record-high close. The broader market indices also advanced on January 22. The S&P 500 rose 6.07 points to 273.91, while the VLA was up 2.75 points to 249.57. At the same time, the March 1987 S&P 500 future settled with a gain of 7.50 points at 276.40. According to a front page Wall Street Journal article on January 19, a typical view of market analysts during this two-week period of sharply rising prices was that the market had substantial profit potential as long as the rally lasted but that traders should "stay fairly close to the exits" because the market may be due for a correction.

II. MARKET ACTIVITY ON JANUARY 23, 1987

During the morning of January 23, stock prices continued the previous day's uptrend by opening higher and moving upward through mid-day. Shortly after 12:30 p.m. (CST), 5/ the Dow was up about 64 points from the previous close. Suddenly the market began to fall, and it kept falling until the Dow was down about 51 points shortly before 2:00 p.m. (CST)--a total down move of about 115 points in the Dow. (See Figure B) During about the next half hour, the Dow briefly recovered to show a gain of about

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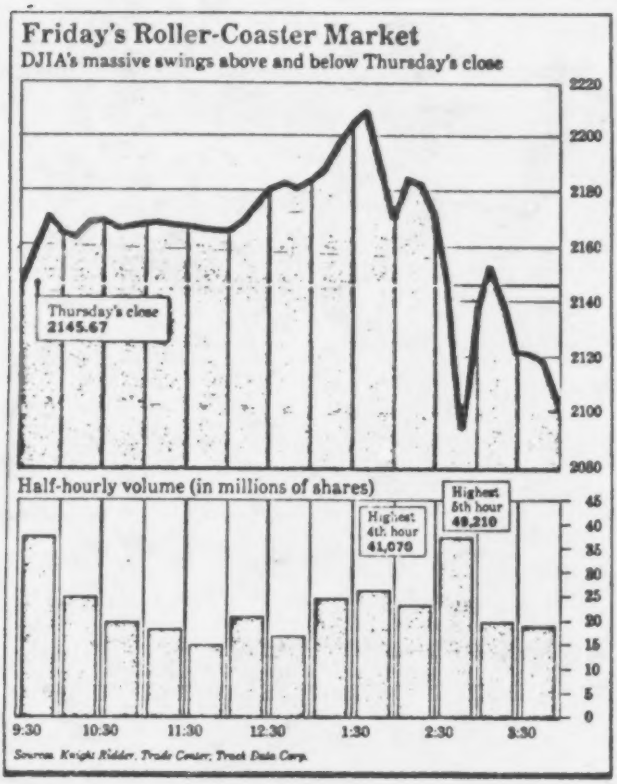
5/ All times referenced in this report are Central Standard Time (CST).

Figure B



(Eastern Standard Time)

Source: Wall Street Journal, January 26, 1987

11, but eventually lost ground again to close at 2101.52--down 44.15 points for the day.

Activity in the various stock market indices and derivatives on January 23 is summarized in Table 2.

Table 2

Trading Activity on January 23, 1987

Index/Market	Price Range	Net Change at Close Points	Percent	Volume
Dow index	151.72	-44.15	-2.1	41.6 mil. shares
S&P 500 index	12.55	-3.81	-1.4	NA
VIA index	4.57	-2.25	-0.9	NA
OEX option*	13.61	-4.47	-1.7	849,318 contracts
Feb. 1987 MMI future	28.75	-12.55	-3.0	17,763 contracts
Mar. 1987 S&P 500 future	16.60	-7.10	-2.6	147,703 contracts
Mar. 1987 VIA future	10.40	-7.40	-3.0	7,454 contracts

* Price data for the OEX index; volume for OEX options.

Volume for the day in all NYSE stocks was about 311 million shares, surpassing the 253-million-share record set on January 15th. Although that day's volume was heavy, liquidity at times was relatively thin. Traders reported that bid/ask spreads on even heavily-traded individual stock issues widened sharply and some questioned the performance of NYSE specialists. The March 1987 S&P 500 futures volume was also high, at over 147,000 contracts. Despite heavy volume the S&P 500 future at times moved in 50- to 100-basis-point increments rather than the usual 5-basis-point ticks, making it difficult for traders and quotation services to keep abreast of the market and to trade on the basis of reported prices.

No new fundamental economic news was reported on January 23 that would have been likely to affect significantly the course of the stock market. Values of the various stock indices and derivatives continued to move upward until early afternoon. During that period of rising prices, however, the S&P 500 futures price advanced more quickly than the underlying index. As a result, the March 1987 S&P 500 traded higher than its fair value, with the premium of futures over cash values estimated to be 100 points. CME price data show that there were opportunities to buy undervalued stocks and sell overvalued futures until about early afternoon. The futures premium ranged from about 119 to 302 points over cash, with a mean of 173 points and a variance of only 7 basis points. Indeed, trade sources interviewed confirmed that they were executing cash-futures arbitrage trades during that period.

Figure C is a graph of a calculated basis--the difference between the March 1987 S&P 500 future and the S&P 500 index--during the day of January 23. These data show a relatively narrow amplitude in the basis prior to 12:30 p.m. From shortly after 12:30 p.m. to the close, however, wide, erratic swings in the basis occurred. The March 1987 S&P 500 future ranged from a discount of 434 points to a premium of 557 points to the cash index. The mean of the differences was a premium of 56 points with a variance of 130 basis points. However, trade sources interviewed said it was difficult to calculate the true relative market

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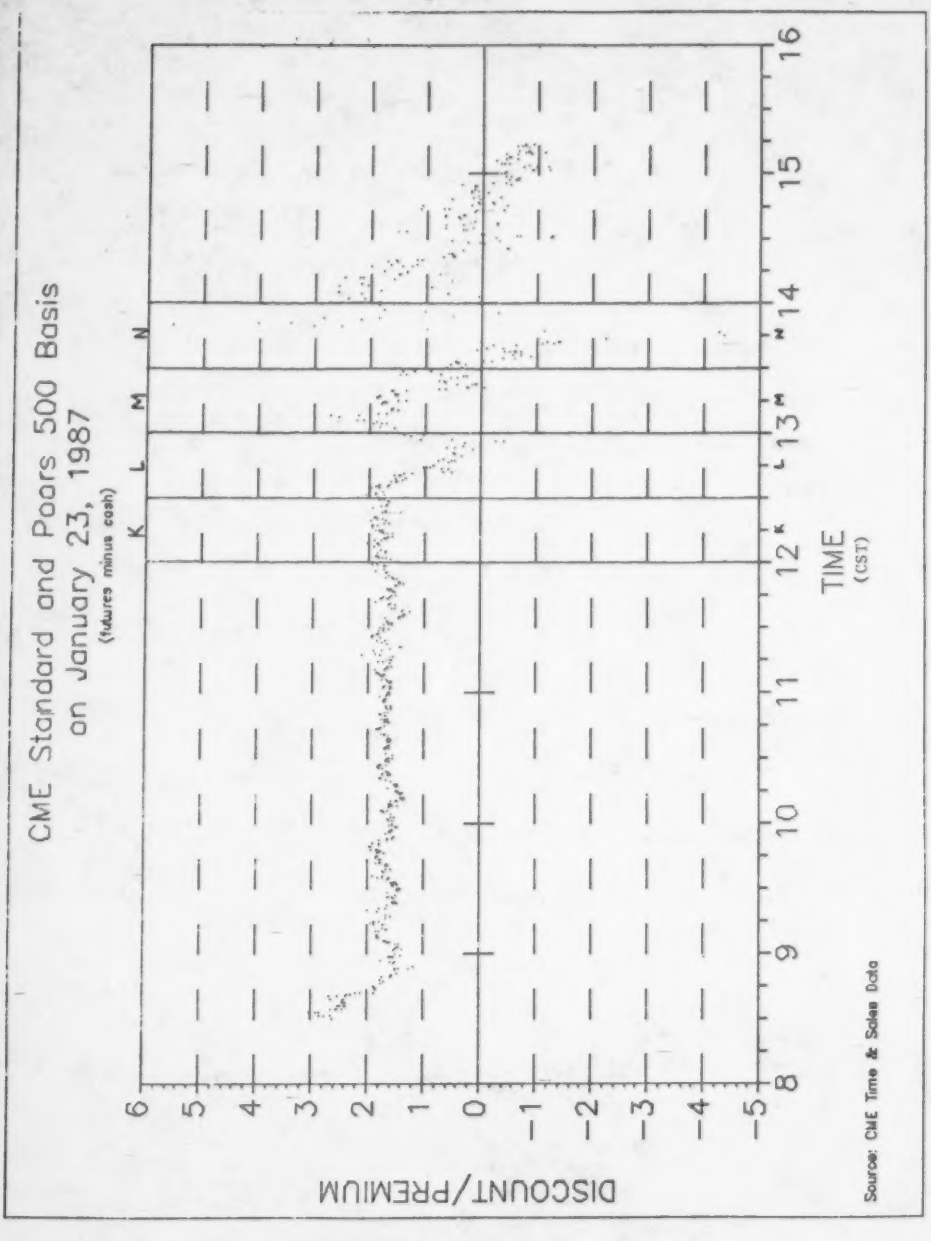
Figure C


CME Standard and Poors 500 Basis
on January 23, 1987
(futures minus cash)
DISCOUNT/PREMIUM
6
5
4
3
2
1
0
-1
-2
-3
-4
-5
K
L
M
N
8
9
10
11
12
13
14
15
16
TIME
(CST)
Source: CME Time & Sales Data

values and to trade on the basis of those calculations during this period. 6/

During the next trading day, Monday, January 26, the Dow traded in a relatively narrow range at prices above and below the previous day's close, ending the day with a small gain of 5.76 points. This relative stability after the sharply lower close on January 23 tends to indicate that the decline in the Dow was the result of rapidly changing market expectations rather than the reflection of some temporary order imbalance or manipulative force from which the market would immediately rebound. In subsequent trading sessions, the Dow and all major stock indices continued trending higher and within a few weeks exceeded even the highest levels reached on January 23.

6/ The calculated difference, or basis, between the last futures price and the last quoted price of its underlying index is not necessarily an accurate reflection of arbitrage opportunities. A trader must consider the current bid/offer for the future and for each of the stocks that is used in the basket of stocks to replicate the index. After 12:30 p.m. on January 23, the bid/offer spreads in all markets became wider than usual. Moreover, Standard & Poors has a policy of verifying relatively large changes in stock quotes before using the new quote in its reported index prices. Since there were large, rapid price changes in many stocks on January 23, it is likely that the latest reported index value did not include all the latest stock prices. As a result of these factors, the calculated basis relationships for that day may be more indicative of the volatility and atmosphere of uncertainty rather than of actual opportunities for arbitrage.

Notwithstanding the fact that closing prices on January 23 do not appear unusual in light of subsequent price levels, the intraday price activity on that day exhibited unusually high volatility. The Dow swung in a 115-point range, or more than 6 percent, in a little over 70 minutes. According to the Wall Street Journal, this was a record intraday swing for the Dow in absolute terms, although it was nowhere near the record in percentage terms. For example, during the "Cuban missile crisis," on May 28, 1962, the Dow had a 59-point swing, or about 10 percent of its value, and closed down 35 points. Even the absolute size of the 115-point trading range on January 23 seems less extraordinary in light of the fact that more recently, on April 3, 1987, the Dow had a swing of over 90 points and closed about 70 points higher.

As noted earlier, this unusual volatility in the various market indices on January 23 focused further attention on the interaction between the stock market and its derivative markets, particularly stock index futures. 7/ Moreover, the speed and magnitude of the price reversal on January 23 raised questions about the possibility that futures market manipulation could have caused or contributed to the large drop in stock indices that

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7/ Up to this point, most of the concerns about the impact of derivative products on the stock market have focused on the quarterly "triple witching days." The previously noted SEC staff report also examined the effects of derivative products on the 120-point decline in the Dow on September 11 and 12, 1986, concluding that index-related trading was not the cause of that decline.

day. Since, however, no specific individual traders or firms were suggested to be possible violators, the Division examined market-wide data to isolate and analyze any traders or firms whose activities might be considered harmful.

This examination of trading activity on January 23, 1987, concentrates on the S&P 500 future since that is the most actively traded stock index future and the vehicle most commonly used for stock index arbitrage. Moreover, traders' open positions and net position changes in the other stock index futures markets were much smaller than those in the S&P 500 future. In this context, the Division examined the largest aggregate trading by exchange clearing members and the largest net futures position changes by individual traders. The Division also examined intraday futures trading activity, especially during those key half-hour or smaller segments when the largest price drops occurred.

III. EXCHANGE MEMBERS' ACTIVITY

Stock Market. The NYSE supplied data to the SEC and the CME for January 23, 1987, showing the NYSE member firms (proprietary and customer accounts combined) that were the 20 largest buyers and 20 largest sellers in all NYSE stocks and in the stocks that comprise three indices. As summarized in Table 3, the 20 largest buyers accounted for about the same proportion of the volume as the 20 largest sellers that day.

Table 3

Volume of the NYSE's 20 Largest Buyers and Sellers
(Proprietary and Customer Volumes Combined)

STOCKS	Total Vol. mil. shares	BOUGHT mil. shares	BOUGHT percent	SOLD mil. shares	SOLD percent
NYSE stocks	311.0	196.6	63.2	191.3	61.5
CEX 100 stocks	95.9	59.6	62.2	56.4	58.8
DOW 30 stocks	41.6	26.9	64.8	26.7	64.2
MMI 20 stocks	36.6	22.5	61.6	24.9	68.0

The two NYSE members whose accounts, in aggregate, were the largest buyers of all NYSE stocks on January 23 were also the largest sellers. Those firms were FIRM-A and FIRM-B. FIRM-A bought 20.9 million shares and sold 20.0 million shares; FIRM-B bought 18.1 million shares and sold 16.4 million shares. Accounts through those two NYSE members were also, in aggregate, the largest buyers and sellers in the 30 Dow stocks. FIRM-A accounts bought 3.0 million shares of those stocks and sold 3.0 million shares; FIRM-B accounts bought 2.5 million shares and sold 2.4 million shares.

The NYSE also provided data for the 20 largest buyers and sellers of stocks for one-hour periods during the trading day on January 23. The Division reviewed these intraday data based on three time periods: from the opening to 12:30 p.m. (CST)--stock prices were generally rising toward their highest levels of the day; from 12:30 p.m. to 1:30 p.m.--prices peaked a few minutes past 12:30 p.m. and began the sharp reversal; 1:30 p.m. to the

closing--prices continued to move sharply lower to the lows of the day, recovered, and then moved lower again.

As summarized in Table 4, these data show that accounts through both FIRM-A and FIRM-B were actively trading and net buyers of NYSE stocks from the opening through 12:30 p.m. (CST), while stock prices were generally rising. During the next period, from 12:30 to 1:30, when the sharp break in prices began, their accounts were much less active and only slightly net sellers. During the remainder of that day, when prices traded erratically lower, recovered, and then moved lower again, their accounts were much less active than during the earlier period, with FIRM-A accounts slightly net sellers and FIRM-B accounts slightly net buyers of stocks. In the 30 Dow stocks, accounts through these two NYSE firms had no significant imbalance in their trading during these selected time periods on January 23.

Table 4

NYSE Member Firms with the Largest Gross Buys and Sells in All NYSE Stocks
(million shares)

Firm	Open to 12:30		12:30 - 1:30		1:30 - Close	
	Bought	Sold	Bought	Sold	Bought	Sold
FIRM-A	15.0	13.6	2.3	2.6	3.6	3.8
FIRM-B	13.1	11.6	2.2	2.7	2.8	2.1

Based on the NYSE data for the 20 largest buyers and sellers, the largest net buyer of all NYSE stocks appears to be FIRM-C,

whose accounts bought 13.1 million shares and sold 9.0 million shares for net purchases of 4.1 million shares. 8/ The largest net seller appears to be FIRM-D, whose accounts bought 6.6 million shares and sold 9.7 million shares for net sales of 3.1 million shares.

As summarized in Table 5, the intraday trading for those two firms show that FIRM-C accounts had most of their net buying during the first part of the day, while prices were moving up. That firm's accounts did relatively little on a gross or net basis during the remainder of the day. FIRM-D also did most of its trading prior to 12:30, and its accounts, in aggregate, were net sellers throughout that day. A review of these two firms' aggregate trading in the 30 Dow stocks shows a pattern similar to their overall trading, with most of the activity taking place early in the day before the sharp reversal.

Table 5

NYSE Member Firms with the Largest Net Buys and Net Sells of NYSE Stocks (million shares)

	Open to 12:30		12:30 to 1:30		1:30 to Close		Day's
Firm	Bought	Sold	Bought	Sold	Bought	Sold	Net
FIRM-C	8.7	4.8	2.0	1.7	2.4	2.5	4.1-B
FIRM-D	4.9	6.9	0.9	1.2	0.9	1.7	3.1-S

8/ The data provided by the NYSE showing the 20 largest gross buying and selling firms do not necessarily disclose all of the firms with the largest net trades either for the day or within certain time intervals because both buy and sell data were not provided for all firms. Nor do the data distinguish proprietary and customer volume.

Since none of the NYSE member firms that had the largest volume totals, gross or net, for the entire day had trading patterns that might have caused or contributed to the sharp break in stock and futures prices, the Division examined the data for the critical period of 12:30 p.m. to 1:30 p.m. when prices began the sharp break. Total NYSE volume during that period was about 50 million shares.

The largest net seller of all NYSE stocks during that critical period appears to be FIRM-E. Its accounts in aggregate had gross sales of about 1.4 million shares and net sales of about 1.0 million shares. FIRM-E was a net seller of NYSE stocks in every time period that day, with total buys of about 6.1 million shares and total sales of about 8.8 million shares. It appears, therefore, that even the largest net seller of stocks during the period when the sharp break in prices began was small relative to total volume for that period and traded in similar fashion throughout the day. Moreover, FIRM-E volume tends to represent largely small retail accounts rather than large institutional accounts.

Futures Market. The Commission routinely requires each futures exchange to provide computer tapes containing the open positions and trading activity of each clearing firm, aggregated separately for proprietary and customer accounts. In addition, for purposes of this report, the Division obtained a computer tape of "matched trades" data from the CME, which lists each cleared trade, the

brokers and firms on the buy and sell sides, execution price, and time interval. 9/

The clearing firms whose accounts, in aggregate, were the three largest buyers of futures on a gross basis were also the three largest sellers on a gross basis. Those three firms were FIRM-F, FIRM-G, and FIRM-H. The accounts of all three firms in aggregate bought 26,471 contracts and sold 26,270 contracts for net purchases of only 201 contracts. The bulk of the trades cleared through those three firms were for local traders who started that day with very little if any open positions, traded actively during the day, and ended up with very little if any open positions.

The Division examined the trading activity through these three firms by half-hour brackets throughout the trading session on January 23. 10/ Since these data are in smaller, half-hour

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9/ The CME experienced an unusually high proportion of initial out-trades for January 23. As a result, about 109,000 March 1987 S&P futures contracts were matched on the first day while over 147,000 were eventually matched by January 30. This analysis of trading on January 23 includes data for all trades cleared by January 30.

10/ During this period, futures traders were required to record the half-hour bracket during which their trades were executed. Although these data contained significant errors (e.g., brackets listed for trades made at prices that did not exist during the specified bracket), the Division staff also was able to use other data sources to assist in reconstructing intraday activity. The improved audit trail system scheduled for implementation by July 1, 1987, should

(Footnote Continued)

intervals compared to the NYSE data in one-hour intervals, the futures trading day was divided into three slightly different segments that more closely relate to the price activity that day. From the opening to 12:30 p.m. (CST)--prices were generally rising toward their highest levels of the day; 12:30 p.m. to 2:00 p.m.--prices peaked shortly after 12:30 p.m., moved sharply lower to their lowest levels of the day, and then traded erratically above those lows; 2:00 p.m. to 3:15 p.m. (the close of the futures market)--prices recovered and then moved lower through the close.

As summarized in Table 6, from the opening through 12:30 p.m. (CST), while prices were in a strong uptrend, the quantities bought and sold through each firm were virtually equal.

Table 6

Three Largest Gross Buyers and Sellers of S&P 500 Futures
(Proprietary and Customer Accounts Combined)

	Open to 12:30		12:30 to 2:00		2:00 to 3:15		Day's
Firm	Bought	Sold	Bought	Sold	Bought	Sold	Net
FIRM-F	4783	4893	3100	2692	1701	1674	325-B
FIRM-G	5170	5140	2761	2987	1445	1419	170-S
FIRM-H	4645	4600	2229	2188	637	677	46-B

(Footnote Continued)
significantly reduce these data deficiencies and permit more accurate trade reconstructions.

For the period from 12:30 p.m. to 2:00 p.m., which included the time when prices had the large downturn (e.g., the Dow moved down 115 points), the futures trading through these three largest clearing firms was also relatively balanced--FIRM-F had net buys of 408 contracts, FIRM-G had net sales of 226 contracts, and FIRM-H had net buys of 41 contracts. From 2:00 p.m. through the close at 3:15 p.m., the largest net trades cleared through any of these three firms was 40 contracts of net sales.

These three firms, whose accounts in aggregate represented the largest gross buyers and sellers of futures, appear to have had little net impact on prices during any particular period of time on January 23. This heavy buying and selling with only small net differences is typical of local traders making a market in futures. Furthermore, the trading through these three firms is not normally associated with corresponding activity in the underlying stocks.

The clearing firm through which the largest net buying took place that day was FIRM-I. Its accounts, which mostly represented institutional customer activity, bought 5280 contracts and sold 1703 contracts for net purchases of 3577 contracts. The net effect of this trading mostly increased long positions. As summarized in Table 7, the FIRM-I accounts did the majority of their net buying through 12:30 p.m., when prices were rising.

However, they also did significant net buying from 12:30 to 2:00 p.m., the period during which prices moved sharply lower.

Table 7

Three Largest Net Buyers of S&P 500 Futures
(Proprietary and Customer Accounts Combined)

Firm	Open to 12:30		12:30 to 2:00		2:00 to 3:15		Net
	Bought	Sold	Bought	Sold	Bought	Sold	Buys
FIRM-I	2846	592	2024	441	410	670	3577
FIRM-J	2849	984	1458	1337	989	450	2525
FIRM-K	4260	3448	1876	788	1153	584	2469

The next two largest net buyers were FIRM-J, mostly for proprietary accounts, and FIRM-K, mostly for customer accounts, with net buys of 2525 contracts and 2469 contracts, respectively. FIRM-J accounts also did most of their net buying through 12:30 and had very small net buying during the remainder of the day. The effect of their net buying generally was to reduce short positions and increase long positions. Most trading through this firm generally represents arbitrage between futures and option markets.

FIRM-K accounts also did their heaviest trading early in the day but had significant net buying throughout the day--before, during, and after the large downturn in prices. Their net buying mostly increased long positions.

The aggregate futures trading through these three largest net buyers does not appear to be related to the substantial price

drop on January 23. Much of their net buying was done prior to the price reversal but continued through the period when prices were moving sharply lower.

While the precise extent to which these large net buyers of futures may have had offsetting selling in the stock market is not known, NYSE data indicate that both FIRM-I and FIRM-K also were large net buyers of stocks for the day. On an intraday basis FIRM-K was a small net buyer of NYSE stocks from 12:30 to 1:30 p.m. and a net seller of NYSE stocks from 1:30 to 2:30 p.m. FIRM-I was a significant net buyer in the first period and a net seller in the second. FIRM-I and FIRM-K had small net futures selling in their proprietary accounts, some of which may have been associated with buying in stocks. The extent to which their customer accounts with heavy futures buying activity may also have been involved in significant stock selling is examined further during the discussion of individual traders' activity in parts IV and V of this report. The trading through FIRM-J is normally associated with offsetting delta-neutral positions in the stock index options and, therefore, was not likely to impact the stock market directly.

The clearing firm through which the largest net selling of futures took place that day was FIRM-L. Their accounts, which were mostly for customers, bought 2541 and sold 6485 contracts

for net sales of 3971 contracts, which mostly decreased long positions. FIRM-L also was a large net buyer of stocks on the NYSE. As summarized in Table 8, the FIRM-L accounts' net futures sales occurred throughout the day, but the majority was done near the end of the day, after the market had already experienced the sharp reversal. NYSE data indicate that FIRM-L also was a net seller of stocks after 1:30 p.m. (CST), particularly during the final half hour of trading on the NYSE.

Table 8

Three Largest Net Sellers of S&P 500 Futures
(Proprietary and Customer Accounts Combined)

Firm	Open to 12:30		12:30 to 2:00		2:00 to 3:15		Net
	Bought	Sold	Bought	Sold	Bought	Sold	Sales
FIRM-L	1529	2108	552	1507	433	2870	3971
FIRM-M	406	1913	200	720	108	79	1998
FIRM-N	798	806	569	1841	228	296	1348

The next two largest net sellers were FIRM-M and FIRM-N, with net sales of 1998 contracts and 1348 contracts, respectively. Neither of these firms are NYSE members. FIRM-M, trading almost entirely for customers, did most of their net selling early in the day prior to the price reversal and continued to a lesser extent during the downturn. The effect of their net selling was mostly to increase short positions.

FIRM-N accounts, which were virtually all for customers, did nearly all of their net selling from 12:30 p.m. to 2:00 p.m., during the major reversal. A closer look at FIRM-N's net

sales of 1272 contracts during that 90-minute period shows that nearly all of their net sales--1113 contracts--took place during the last 30 minutes, when stock index and futures prices fell precipitously and then recovered. As a result, it appears that although their net selling did not occur near the initial break in prices, it may have helped weaken the market later as it moved to its lowest level of the day. (The intrabracket activity by individual accounts is examined in part V.) The effect of FIRM-N's net selling that day was mostly to increase short positions.

In summary, data showing the largest aggregate trading through exchange member firms--NYSE and CME--does not reveal any one firm as being a principal contributor to the price reversal and large price drop on January 23. Futures selling through two firms, however, could have contributed to futures price declines later in the afternoon. Since trading by large proprietary or customer accounts through a brokerage firm may tend to offset each other or otherwise obscure the separate actions of large individual traders, this report next examines futures data for individual traders. 11/

11/ As of the writing of this report the Division was unable to secure data from the NYSE or SEC on the stock trading of individual proprietary or customer accounts. Consequently, the remainder of this analysis examines the detailed data for futures transactions and positions that the Commission routinely receives from exchanges, brokers (i.e., futures commission merchants, clearing members, and foreign

(Footnote Continued)

IV. INDIVIDUAL TRADERS' ACTIVITY

Data received through the Commission's large-trader reporting system 12/ show that there were 43 traders that were net buyers or net sellers of 200 or more March 1987 S&P 500 futures contracts on January 23--26 were net buyers and 17 were net sellers. Focusing on the largest of these net buyers and net sellers, Market Surveillance staff conducted interviews and examined intraday trading activity to analyze the nature and possible effects of their trading. Intraday trading was particularly examined for the periods when prices first peaked (12:30 to 1:00 p.m.) and when, after recovering, they plunged to the lows of the day (1:30 to 2:00 p.m.). (See Figure D)

Net Buyers. Table 9 shows the futures positions and net changes for the six largest net buyers of S&P 500 futures on January 23, i.e., traders with increased net long and/or decreased net short positions.

(Footnote Continued)
brokers), and individual traders as well as transaction data specifically requested from the CME.

12/ Futures commission merchants (FCMs), clearing members, and foreign brokers are required to provide the Commission with daily reports of positions for every trader that exceed a level set by the Commission. For S&P 500 futures the reporting level is 300 contracts in any one future.

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Figure D

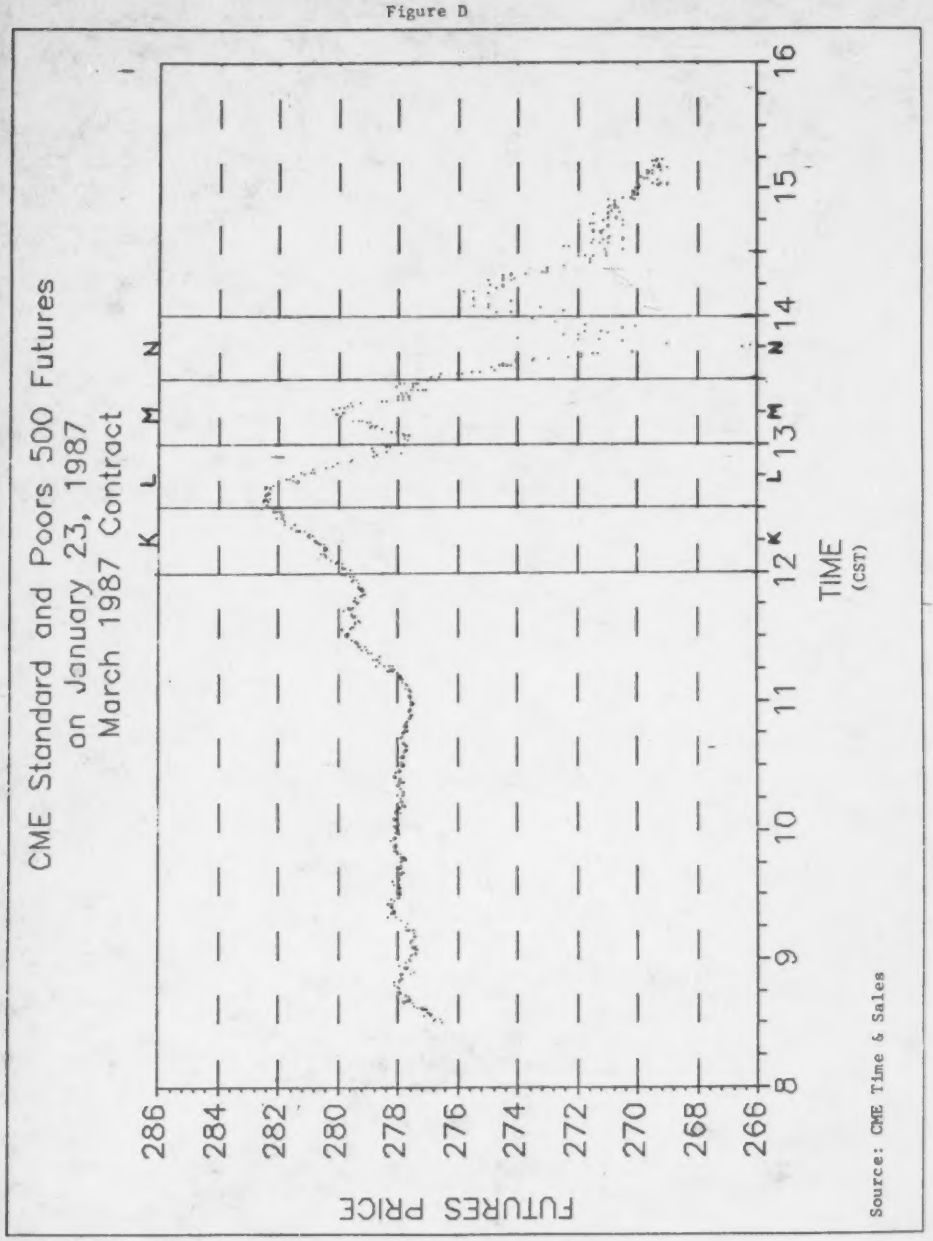
CME Standard and Poors 500 Futures
on January 23, 1987
March 1987 Contract
FUTURES PRICE
286
284
282
280
278
276
274
272
270
268
266
K
L
M
N
8
9
10
11
12
13
14
15
16
TIME
(CST)
Source: CME Time & Sales

Table 9

Six Largest Net Buyers of Futures on January 23

Trader	Position 1/22		Position 1/23		Net Change	
	Long	Short	Long	Short	Long	Short
TRADER-O	9,493	223	11,671	223	+2,178	0
TRADER-P	0	0	2,080	0	+2,080	0
TRADER-Q	414	5,520	715	4,220	+ 301	-1,300
TRADER-R	0	5,743	0	4,785	0	- 958
TRADER-S	0	1,150	0	400	0	- 750
TRADER-C	1,119	2,997	1,199	2,427	+ 80	- 570

TRADER-O, a hedge fund, 13/ was the largest net buyer of futures on January 23, with net buys of 2178 contracts. Their net buying resulted in an increase in their long futures position from 9493 contracts to 11,671 contracts. Based on "matched trades" data obtained from the CME, the Division was able to reconstruct the trader's intraday activity by half-hour brackets. TRADER-O (trading through FIRM-K and FIRM-T) was a net buyer in every bracket it traded that day, except the K Bracket (12:00 - 12:30 p.m.) when it sold 100 contracts. More than three-fourths of its total net buying that day took place after 1:30 p.m., by which time prices had already fallen well below the high of the day.

TRADER-P, a foreign investment company, was the second largest net buyer of futures, purchasing 2080 contracts to establish a

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13/ A hedge fund is a private securities investment pool that typically can sell short securities, trade futures and options, and trade on margin. Furthermore, the fund manager normally receives a percentage of profits, typically around 20 percent, instead of a flat management fee.

new long futures position. Intraday data show that TRADER-P (trading through FIRM-I) bought 1100 contracts by 11:00 a.m. on January 23 and the remaining 980 contracts from 12:30 to 2:30 p.m.; the firm did no selling that day. Its largest buys in any one bracket were 350 contracts from 1:00 p.m. to 1:30 p.m., during which prices recovered part of the initial drop but then began falling again.

TRADER-Q and TRADER-S were both carrying short futures positions into January 23 as "portfolio insurance." 14/ Their net buying of 1601 and 750 contracts, respectively, reduced their net short futures positions. The manager at TRADER-Q explained that their buying of futures during the morning was in line with their portfolio insurance strategy of increasing long exposure as prices increased. Matched trades data show that TRADER-Q (trading through FIRM-I) bought from 100 to 300 contracts in each half-hour bracket from 8:30 a.m. through 1:00 p.m. that day. The manager at TRADER-S said their portfolio insurance model indicated the buying of futures on January 23 as the result of the price increases on January 22. He could not recall why they only bought 750 contracts that day because they normally trade 1400 contracts at a time, which is equivalent to about 10 percent of the value of their portfolio. Intraday data show that

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14/ Portfolio insurance is a hedging strategy that in its simplest form uses futures to reduce a stock portfolio's exposure as prices decline and to increase the exposure as prices increase.

TRADER-S (trading through FIRM-K) bought all their 750 contracts from 11:30 to 12:30, while prices were generally rising.

TRADER-R, a local trader who arbitrages futures against options, had net buys of 958 contracts to reduce an existing short futures position. From the open until about 1:00 p.m., TRADER-R (trading through FIRM-U) had small gross buys and sales that were virtually equal, amounting to less than 25 gross contracts in each bracket. From 1:00 to 2:00 p.m., he had net buys of 397 contracts, and from 2:30 p.m. through the close, he had net buys of 581 contracts.

TRADER-C, a securities broker/dealer that engages in substantial stock/futures arbitrage, had net buys of 650 contracts, which mostly reduced an existing short futures position. Intraday data show that TRADER-C (trading through their own firm and through FIRM-V) did most of their net buying from 1:30 to 2:00 p.m., well after the sharp price reversal began but during the time when prices again fell sharply to their lows of the day and then recovered.

Normally one would not expect a net futures buyer to be the cause of a falling futures price unless the trader previously had attempted a flurry of selling in hopes of establishing momentum to drive prices lower in order to cover at a later time and at better prices an existing short futures position. A review of

the trading of these six largest net buyers of futures shows no indication that any of them caused, or positioned themselves to take advantage of, the sharp downward futures price move that took place after 12:30 p.m. on January 23.

Another concern expressed relates to the extent to which these or other large buyers of futures were large sellers of stocks and, therefore, had a depressing effect on prices in that market. Only one of these six buyers of futures is generally involved in offsetting securities transactions--TRADER-C. NYSE data indicate that, for customer and proprietary accounts combined, FIRM-C was a large net buyer of stocks on January 23. After 1:30 (CST), however, the firm was a moderate net seller on the NYSE. Other large buyers of futures who were likely to be involved in selling stocks are discussed later in this section.

Net Sellers. Table 10 shows the S&P 500 futures positions and net changes for the six largest net sellers of futures on January 23, i.e., traders with decreased net long and/or increased net short positions.

Table 10

Largest Net Sellers of Futures on January 23

Trader	Position 1/22		Position 1/23		Net Change	
	Long	Short	Long	Short	Long	Short
TRADER-W	2,950	0	738	0	-2,212	0
TRADER-X	0	258	0	2,182	0	+1,924
TRADER-Y	2,328	0	1,795	385	- 533	+ 385
TRADER-Z	2,174	0	1,269	0	- 905	0
TRADER-AA	0	1,000	0	1,750	0	+ 750
TRADER-B	1,987	204	1,296	204	- 691	0

TRADER-W, an "insured index fund," 15/ was the largest net seller, with net sales of 2212 contracts. The manager explained that when the portfolio insurance model they were using triggered the selling of futures, the fund sold large dollar amounts of futures contracts as quickly as possible on January 23. Since the plan sponsor did not give discretion to the manager as to when the futures were to be sold, selling into an "undervalued futures" market late in the day was not a major consideration. If he had had more discretion, he might not have sold futures at that time but would have waited for the market to stabilize, he explained. Intraday data are not discernible for TRADER-W because they were trading through a large omnibus account at FIRM-L that included many other nonrelated accounts. Nevertheless, since TRADER-W was selling to liquidate part of a large long futures position, they were not in a position to benefit from the sharp downward price move on January 23.

TRADER-X and TRADER-B, both of which were involved in stock/futures arbitrage, were net sellers of 1924 and 691 contracts, respectively. They each were buying stocks and selling futures during the morning as the futures traded at over a

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15/ An index fund attempts to match or exceed the return on a stock index, often the S&P 500, by using combinations of stocks, futures, and fixed-income instruments. An insured index fund uses portfolio insurance to assure a minimum return at the expense of not participating fully in stock market rallies.

302-basis-point premium to cash, while fair value was about a 100-basis-point premium. For the day, TRADER-X (trading through FIRM-M) bought 20 contracts and sold 1944 to increase an existing short futures position. Of its total sales, 1511 contracts were sold prior to 12:30 p.m., while prices were generally moving higher, and its remaining sales of 433 contracts occurred between 12:30 to 1:30 p.m., when prices hit their peak and moved sharply lower. TRADER-B (trading through its own clearing firm) was unwinding existing short-stock/long-futures arbitrage positions and made virtually all of its futures net sales prior to 12:30 p.m., the largest of which was 539 net sales from 12:00 to 12:30 p.m. as the market was rising toward its high for the day.

TRADER-Y and TRADER-Z, both of which are "index funds," were net sellers of 918 and 905 contracts, respectively. The fund manager for TRADER-Y explained that he was selling into the rally during the morning to reduce their equity exposure. Intraday data show that TRADER-Y sold 548 contracts through FIRM-C that day, 528 of which were sold prior to 12:30 p.m. Most of the remainder was traded through the omnibus account at FIRM-L and could not be timed. The manager of the TRADER-Z fund explained that he was switching out of overvalued futures and into undervalued stocks. Intraday data show that TRADER-Z sold 467 contracts through FIRM-K that day,

462 contracts of which were sold prior to 12:30 p.m. The remainder was through the omnibus account at FIRM-L.

TRADER-AA, an investment partnership, was a net seller of 750 contracts during the day, which increased an existing short futures position. The administrator explained that it has about $275 million in capital and that its activity on January 23 was basically hedging existing long stocks positions. Intraday data show that TRADER-AA (trading through FIRM-BB) bought 204 contracts and sold 954 contracts that day. TRADER-AA generally sold throughout the day, with about half of its sales before 12:30 p.m. The largest net sales in any bracket were 133 contracts from 12:30 to 1:00 p.m., the period during which the market peaked and began its plunge. TRADER-AA also bought 200 contracts and sold 210 contracts from 1:30 to 2:00 p.m., the period during which prices completed their fall to the lows for the day and started to move higher.

These data on the individual traders that were the six largest net sellers of futures on January 23 show that four (TRADER-W, TRADER-Y, TRADER-Z, and TRADER-B) were largely liquidating portions of existing long futures positions and had nothing to gain from the sharp downward reversal in prices that occurred shortly after 12:30 p.m. that day. Moreover, with the possible exception of TRADER-W, most of the selling by those four traders appears to have taken place prior to 12:30 p.m. The other two traders increased existing short

futures positions--the larger of the two (TRADER-X) did over three-fourths of its selling prior to 12:30 p.m. in the face of rising prices; the other (TRADER-AA) was selling relatively small quantities throughout the day. To whatever extent these six or other large sellers of futures were involved in offsetting arbitrage activity in stocks, they generally would have been buying stocks and therefore would appear to be neither causes nor beneficiaries of falling prices in that market.

In summary, the trading by the individual traders with the largest net buying or selling of futures on January 23 does not appear to have triggered or aggravated the major price reversal. Nor do those traders appear to have placed themselves in a position to create unusual gains from such a move.

Program Trading and Portfolio Insurance. In addition to examining the largest individual net buyers and net sellers of futures, the Division examined the aggregate activity of traders believed to be involved in various trading strategies generally known as "program trading" or portfolio insurance. 16/ (See Attachment 3) Of the 43 traders with net long or short futures

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16/ Program trading includes various complex trading strategies (generally computer programmed) that involve the simultaneous purchase of a large number of stocks. Such strategies also often involve direct arbitrage or substitution between stock index futures (or options) and the stocks that compose the index (e.g., stock/futures arbitrage or index fund swaps).

position changes of 200 or more contracts in the March 1987 S&P 500 future on January 23, the Division identified 18 traders whose futures activity is generally associated with some form of index-related stock trading--ten stock/futures arbitrageurs, four index funds, and four portfolio insurance users. 17/

Of the ten traders within the stock/futures arbitrage category, six were net sellers of a total of 4111 futures contracts, and four were net buyers of a total of 1801 contracts. Under the broad assumption that all of the net selling and net buying of March S&P 500 futures by those ten traders was establishing or unwinding stock/futures arbitrage, an estimated $559 million of stocks or 9.3 million shares, approximately 3.0 percent of the NYSE January 23 volume, may have been bought in connection with such trades, and $245 million of stocks or 4 million shares, approximately 1.3 percent of the NYSE volume, may have been sold in connection with such trades on that date. This estimate indicates that net purchases of stocks on that day of about 5.3 million shares, valued at about $314 million, may have resulted from stock index arbitrage trading. Most of this activity apparently occurred in the morning before prices began to plunge.

17/ As previously noted, the NYSE has not yet made available to the Division requested data on the purchases and sales of stocks by beneficial owners. As a result, the analysis in this section is based solely on futures market data.

Of the four traders identified as index funds, one, which had net futures sales of 918 contracts, reduced its equity exposure by selling futures and executed no corresponding stock transactions. Two index funds, with a total long futures position of 2705 on January 22nd, sold a total of 1106 contracts and simultaneously bought the underlying stocks in the index. This strategy, which involved the swapping of overvalued futures for undervalued stocks, resulted in the buying of an estimated $150.4 million of stocks or 2.5 million shares, approximately 0.8 percent of the NYSE volume on January 23. The fourth index fund was a "synthetic" index fund that does not utilize a portfolio of stocks in its index fund but instead replicates an index position by using S&P 500 futures. On January 23rd, this synthetic index fund increased its long March futures position by 208 contracts.

Three of the four traders identified as portfolio insurance users reduced net short positions and, therefore, had total net buying of 2599 futures contracts. The other portfolio insurer reduced a long futures position with a total net sale of 2212 contracts. Thus, in aggregate those four traders were net buyers of 387 contracts on January 23. The market rally on the preceding days and on the morning of January 23rd apparently triggered the purchase of S&P 500 futures by three of the four portfolio insurance users. The portfolio insurance trader that sold futures on January 23 reportedly did so near the lows of the day in response to the intraday market decline. None of these futures transactions was linked with transactions in stocks.

Furthermore, their timing, magnitude and direction indicate that portfolio insurance activity was not a principal cause of the price collapse that day.

In summary, for all 43 traders with net changes of 200 or more contracts in the March 1987 S&P 500 futures on January 23, it appears a significant number were involved in various types of program trading or portfolio insurance. Nevertheless, the staff's estimate of the associated trading in stocks by these large institutional users of futures represents less than 5 percent of total volume in NYSE stocks that day and is not likely to have had significant impact on price levels in either market, unless perhaps it was concentrated in a relatively short period of time. 18/ Overall, therefore, the Division concludes that, among individual traders that had large net position changes on January 23, none appear to have been large enough or traded in a manner to cause the major price reversal on January 23.

18/ The percentage of volume in NYSE stocks associated with program trading on January 23 is much less than that observed on September 11 and 12, 1986, when the Dow fell 120 points on record-high volume. In a SEC staff review of those two days, the Division of Market Regulation found that seven large firms effected index-related trading representing over 17 percent of the volume (i.e., nearly 84 million shares worth $3.8 billion), and, although nearly all the index-related trading resulted in the selling of stocks, index-related activity was not the primary source of those market declines.

V. INTRADAY FUTURES TRADING

The previous examination of traders who had significant net buying or selling of S&P 500 futures over the entire day of January 23 did not address issues that related to traders who may have had significant trading during certain critical times that day. Using the matched-trades data obtained from the CME, the Division examined the futures trading activity for certain key half-hour brackets. By combining those data with the CME's "time and sales" data (i.e., the official record of the time of every futures price quoted that day to the nearest 10 seconds), the Division also was able to do computer analyses of traders' activities within those brackets.

The March 1987 S&P 500 futures price peaked early in the L Bracket (12:30 to 1:00 p.m.) at 282.65, which was up 6.25 points from the previous day's close, and then began to move sharply lower. (See Figure D above.) During that bracket, the futures price also declined relative to the cash index quotes and was briefly quoted at prices below concurrent cash index values, which should have presented opportunities to buy undervalued futures and sell stocks.

During the following M Bracket (1:00 to 1:30 p.m.), prices first recovered from part of the decline but then fell again. The fall in prices became steeper during the N Bracket (1:30 to 2:00 p.m.) with large gaps between quotes. The Dow fell about 85 points

during N Bracket and, about midway through that bracket, the March 1987 S&P 500 futures price hit that day's low of 266.00, which was down 10.40 points from the previous day's close and down 16.65 points from the high of the day. Later in the N Bracket, prices moved erratically up from the lows. The futures price reached its lowest levels versus cash index quotes early in the N Bracket and later in that same bracket reached its highest levels versus the cash index.

The Division's analyses of intraday data focused on the L Bracket, during which prices peaked and began to move sharply lower, and the N Bracket, during which prices again fell sharply with large gaps to the lows of the day. These are the brackets during which the greatest price volatility occurred--particularly on the downside.

L Bracket. Total volume in the March 1987 future during this bracket was almost 15,000 contracts. The largest net buyer, the largest net seller, and the largest trader on the basis of gross trades are shown in Table 11 below. No other traders had gross buy or sells of more than 350 contracts, which is less than 3 percent of the volume during that bracket.

Table 11
Largest Traders in Bracket L (12:30 - 1:00 p.m.)

Trader	Bracket L			All Day		
	Bought	Sold	Net B/S	Bought	Sold	Net B/S
TRADER-II	350	0	350-B	500	200	300-B
TRADER-X	0	307	307-S	20	1944	1924-S
TRADER-JJ	676	603	73-B	3423	3311	112-B

The largest net buyer for Bracket L was TRADER-II, a speculative investment fund, which bought 350 contracts (through FIRM-KK) and sold none. TRADER-II started that day with a short futures position of 300 contracts. Early in the day, TRADER-II bought 150 contracts to liquidate half of its short position. Then, shortly after 12:00 p.m. (in the K Bracket) TRADER-II sold 200 contracts, all at a price of 280.00, to increase its short position to 350 contracts. About midway through the L Bracket, several minutes after prices peaked at 282.65 and began their sharp fall, TRADER-II liquidated its entire 350-contract short position by buying futures at prices from 280.40 through 280.50. TRADER-II did no other trading during the remainder of that day. TRADER-II's selling while prices were rising and buying while prices were falling would have tended to moderate the market trends that day, rather than cause or accelerate them. Nor was TRADER-II in a position to benefit from the drop in prices that ensued.

The largest net seller for Bracket L was TRADER-X, which bought none and sold 307 contracts. TRADER-X was also one of the largest net sellers for that entire day. As discussed in part IV above, the firm started the day with a small short futures position and was initiating long-stock/short-futures

arbitrage trades through the early afternoon, about three-fourths of which took place prior to 12:30 p.m. TRADER-X's trading was not of a type that would have caused or placed itself in a position to create unusual gains from the major price reversal that day.

The largest trader on a gross basis for Bracket L was TRADER-JJ, a commodities dealer and CME clearing member. TRADER-JJ began the day short 1430 contracts and ended the day with a slightly reduced short position. In the L Bracket it bought 676 contracts and sold 603 contracts. TRADER-JJ bought 402 contracts and sold 1 contract at prices from 282.00 to 282.50, some of the highest prices traded that day, which were quoted for several minutes after 12:30 p.m. During the next several minutes, at prices ranging from 280.00 to 281.75, TRADER-JJ bought 200 contracts and sold 602 contracts. During the last several minutes of Bracket L, TRADER-JJ bought 74 contracts at 279.00 to 279.80. Based on this pattern of large net buying at some of the highest prices of the day and selling later in the same bracket at lower prices, it does not appear that TRADER-JJ was trying to cause or position itself for the price reversal that began during that bracket. Furthermore, TRADER-JJ's futures activity is not known to be associated with stock trading.

N Bracket. The lowest price for the March 1987 S&P 500 future occurred in the N bracket (1:30 to 2:00 p.m.) at 266.00. Total volume during this bracket was about 20,000 March 1987 futures

contracts. The largest net buyer, the largest net seller, and the largest trader on the basis of gross trades are shown in Table 12. All other traders had gross buys or sells of fewer than 500 contracts, or less than 3 percent of the volume during that bracket.

Table 12

Largest Traders in Bracket N (1:30 - 2:00 p.m.)

Trader	Bracket N			All Day		
	Bought	Sold	Net B/S	Bought	Sold	Net B/S
TRADER-O	824	0	824-B	2230	100	2130-B
TRADER-LL	0	661	661-S	0	661	661-S
TRADER-C	750	164	586-S	1103	493	610-B

The largest net buyer for Bracket N was TRADER-O, a hedge fund, which bought 824 contracts and sold none. TRADER-O was also one of the largest net buyers for that entire day. As discussed in part IV above, TRADER-O began the day with a relatively large long March 1987 futures position of 9493 contracts and ended the day long 11,671 contracts. The heaviest net buys took place beginning in the N Bracket, during which prices fell sharply to the low of the day and then moved up erratically. TRADER-O's trades were executed at prices no lower than 270.00 during that bracket, well above the day's low price of 266.00 that occurred during that bracket. Moreover, their buying would have tended to moderate the sharp decline in futures during that period.

The biggest net seller for Bracket N was TRADER-LL, a registered commodity trading advisor, who bought none and sold 661 contracts (through FIRM-N) to liquidate a speculative long position and establish a nearly equal short position. His customer trading program was confined to the futures market and was based strictly on a computerized model using moving averages. He had resting limit orders in the pit to offset the long position and go short at a price of 275.70.

TRADER-LL commented that there was an unusually high degree of slippage before the resting sell order was filled. All of the sells were filled at prices from 275.40 down to 272.70 from 1:30 p.m. to 2:00 p.m., as prices were falling sharply and eventually hit the lows of the day before moving higher. 19/ Although the selling triggered when this stop order was hit may have given more momentum to a market that was already falling, the selling occurred well after the price reversal began, and the seller had nothing to gain from the drop in prices.

The largest trader on a gross basis in Bracket N was TRADER-C, which bought 750 and sold 164 contracts. As noted in an earlier section, TRADER-C, a broker/dealer that does substantial stock/futures arbitrage, was mostly reducing an

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19/ TRADER-LL accounted for a major portion of the total net futures selling through FIRM-N during this bracket that was discussed in Section III above.

existing short futures position that day. Their trading in Bracket N, during which the futures price reached its lowest levels relative to concurrent cash index quotes, is consistent with a strategy of unwinding existing short-futures/long-stocks arbitrage positions by buying futures and selling stocks.

TRADER-C's likely arbitrage activity in Bracket N is consistent with additional data the Division obtained from the CME. The CME selected traders who were gross buyers or gross sellers of 100 contracts or more in any one bracket and divided them into four categories--broker/dealer, commercial/institutional, market maker/local, and speculative. Especially noteworthy from their summary table (Attachment 4) is the fact that, from Bracket M through Bracket Q (from 1:00 to 3:00 p.m.), the broker/dealers as a whole were net buyers of futures in each of the brackets, buying a total of 3922 and selling a total of 1199. Broker/dealers in aggregate were particularly large net buyers in Bracket N, with 2224 buys and 484 sells, which in light of relative values at the time (futures fell below quoted cash index prices in Bracket N) would be consistent with a strategy of buying futures and selling stocks to unwind short-futures/long-stocks arbitrage.

In addition to the preceding analysis of trading activity during the L and N brackets, the Division also examined futures trading activity for several narrower time intervals within those brackets that had significant price activity. As indicated in Figure

E, trading activity in three separate segments of Bracket L and four segments of Bracket N were examined. For example, the staff looked at the periods when prices were trading at the highs of the day (from 12:30 to 12:42 p.m., when prices were 281.95 or higher), when prices began to break from those highs (from 12:42 to about 12:51 p.m., when prices were from 280.00 to 281.95) and when prices were near the lows of the day (from 1:43 to about 1:48 p.m., when prices were under 270.00). 20/

The staff looked at trading activity within each of the seven intervals for the purpose of finding whether any single trader or group of traders with similar strategies (e.g., program traders) was large enough to affect the price during a brief interval. The staff specifically observed whether any accounts were large buyers or sellers compared to the general size of trading in each interval and whether there was any imbalance on the buy side or sell side among the larger accounts.

As a result of this review, the Division found only one brief period of time where there was an unusual pattern or concentration of futures trading activity. From about 1:34 to 1:39 p.m. during bracket N, when prices ranged from 274.00 to 276.00, there is evidence of heavy futures buying by traders who are normally

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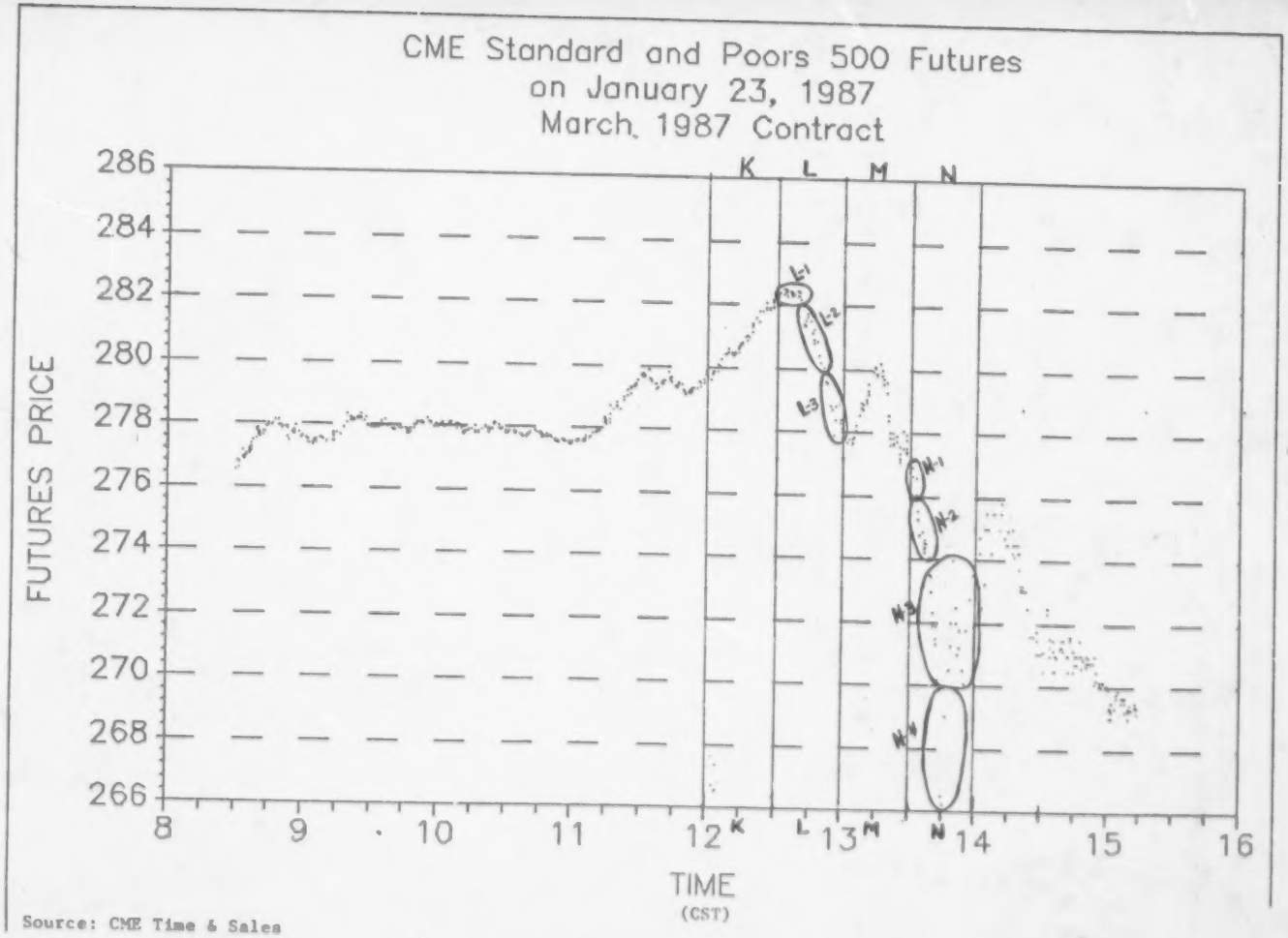
20/ The CME's "matched trades" and "time and sales" data, as they existed then, permit only general observations. (See footnote 10.)



Source: CME Time & Sales

Figure 3

associated with program trading. During those several minutes, which occurred nearly an hour after the sharp break began, the futures price was below concurrent index values and invited unwinding of long-stock/short-futures arbitrage positions and/or index substitution (in which an index fund sells a portion of its stock portfolio and buys index futures contracts).

Lack of comparable timed transactions data for stocks makes it difficult to assess to what extent the heavy buying of futures during those several minutes was in fact associated with selling stocks. The securities industry's "uptick rule" likely inhibited short sales of stocks to initiate short arbitrage positions, although there may have been index substitution activity. However, it appears that most of the futures buying was liquidating existing short futures positions, which is consistent with the unwinding of existing short-futures/long-stocks arbitrage positions.

The inaccuracies of timing futures trades and the lack of timed stock trading data for individual firms also make it impossible to estimate the relative price impact of these trading activities on stocks or futures during those several minutes. Nevertheless, due at least in part to the heavy execution of these strategies, futures and stock trading volumes were at or near their highest levels of that trading day, which was a record-high volume day in stocks and a very high volume day in futures. The relative size of the arbitrage trades, therefore, was small in the face of the

unusually high volume, and the likelihood of significant price effect was diminished.

In summary, the Division's review of intraday futures trading activity, although based on reconstructing data that are subject to certain gaps and inaccuracies, allows two general conclusions. First, for the period shortly after 12:30 p.m. when stock and futures prices began the sharp break, no traders appear to have traded futures in sufficient quantities or in a manner to affect futures prices unduly. Second, nearly an hour after the initial price break, weak futures prices relative to concurrent cash index quotes attracted futures buying that was apparently associated with selling of stocks, most likely to unwind existing short-futures/long-stocks arbitrage positions. The quantities of stocks sold as part of those activities, however, do not appear to be large enough relative to the volume in the stock market to have caused the further sharp prices drops that ensued.

Attachments 1-4 follow:

Attachment 1

Largest Drops of DJIA

DATE	CLOSE	DECLINE	% CHG.
Sept. 11, '86	1792.89	86.61	-4.61%
July 7, '86	1839.00	61.87	-3.25
Mar. 30, '87	2278.41	57.89	-2.48
April 13, '87	2287.07	51.71	-2.21
June 9, '86	1840.15	45.75	-2.43
April 7, '87	2360.94	44.60	-1.85
Jan. 23, '87	2101.52	44.15	-2.06
Nov. 13, '86	1817.21	43.31	-2.33
Apr. 30, '86	1783.98	41.91	-2.30
Jan. 8, '86	1526.61	39.10	-2.50

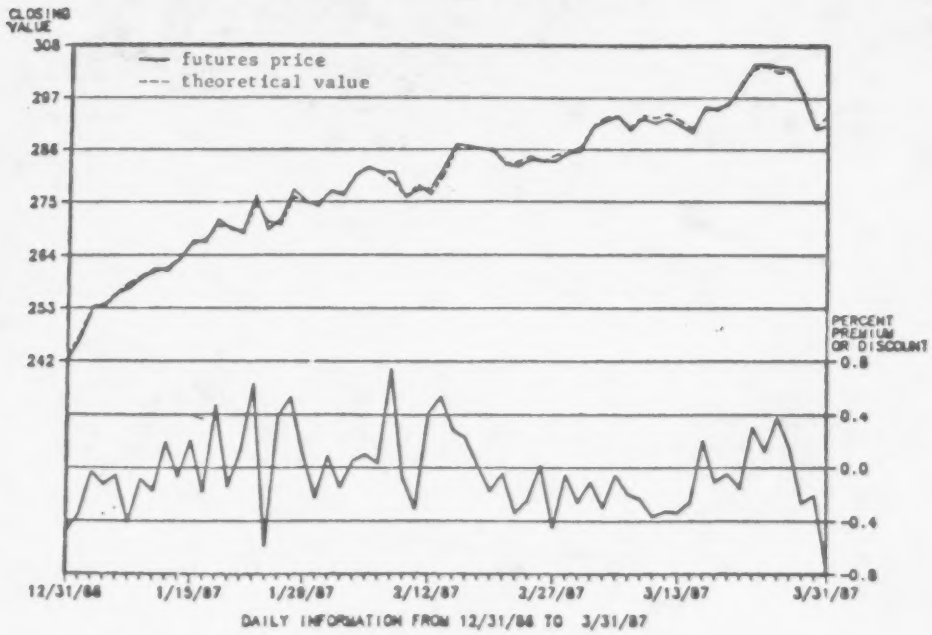
Biggest One-Day Gains

DATE	CLOSE	GAIN	% CHG.
April 8, 1987	2390.34	69.89	3.01
April 21, 1987	2337.07	66.47	2.93
Feb. 17, 1987	2237.49	54.14	2.48
Jan. 22, 1987	2145.67	51.60	2.46
Jan. 5, 1987	1971.32	44.01	2.28
Nov. 3, 1982	1065.49	43.41	4.25
Jan. 27, 1987	2150.45	43.17	2.05
March 11, 1986	1746.05	43.10	2.53
Dec. 2, 1986	1955.57	43.03	2.25
March 14, 1986	1792.74	39.03	2.23

Source: Wall Street Journal

Attachment 2

S&P 500 NEARBY FUTURES PRICE VERSUS ITS THEORETICAL VALUE



Source: Goldman Sachs, "Stock Index Research," March 1987

Attachment 3

PROGRAM TRADERS

TRADER	CLASS	JAN 23 LONG	JAN 23 SHORT	JAN 23 NET POSITION	CHANGE LONG	CHANGE SHORT	NET POSITION CHANGE	TRADER ID
			STOCK/FUTURES ARBITRAGERS					
TRADER-C	C	1199	2427	-1228	80	-570	650	BROKER/DEALER
TRADER-CC	C	3311	0	3311	491	0	491	BROKER/DEALER
TRADER-DD	N	49	0	49	49	-360	409	CORPORATE CASH MGMT.
TRADER-E	C	0	255	-255	0	-300	300	BROKER/DEALER
TRADER-L	C	471	3060	-2589	-25	240	-265	BROKER/DEALER
TRADER K	C	145	1443	-1298	-411	-111	-300	BROKER/DEALER
TRADER-EE	N	0	400	-400	0	400	-400	CORPORATE CASH MGMT.
TRADER-BB	C	15	1964	-1949	-6	525	-531	BROKER/DEALER
TRADER-B	C	1296	204	1092	-691	0	-691	BROKER/DEALER
TRADER-X	C	0	2182	-2182	0	1924	-1924	BROKER/DEALER
			INDEX FUNDS					
TRADER-FF	C	689	0	689	208	0	208	SYNTHETIC INDEX FUND
TRADER-GG	C	330	0	330	-201	0	-201	INDEX FUND
TRADER-Z	C	1269	0	1269	-905	0	-905	INDEX FUND
TRADER-Y	C	1795	385	1410	-533	385	-918	INDEX FUND
			PORTFOLIO INSURANCE USERS					
TRADER-Q	C	715	4220	-3505	301	-1300	1601	PORTFOLIO INSURANCE
TRADER-S	C	0	400	-400	0	-750	750	PORTFOLIO INSURANCE
TRADER-HH	C	664	1428	-764	45	-203	248	PORTFOLIO INSURANCE
TRADER-W	C	738	0	738	-2212	0	-2212	PORTFOLIO INSURANCE

Note: For purposes of calculating the amount of stocks and futures transacted for TRADER-DD in connection with stock/futures arbitrage, an estimate of 360 contracts bought was used. Their representative could not explain the day ending net long position of 49 contracts since the unwinding of the long stock/short futures arbitrage trade on the 23rd should have brought their position down to zero.

January 23, 1987: March 1987 S&P 500 FUTURES

Bracket C-G (8:30-11:00)	Broker/ Dealer Bot	Broker/ Dealer Sold	Commercial/ Institutional Bot	Commercial/ Institutional Sold	Market Maker/ Local Bot	Market Maker/ Local Sold	Speculative Bot	Speculative Sold	Total of Accts With 100 or more Bot	Total of Accts With 100 or more Sold	Total S&P Vol by Bracket: Buys Plus Sells	Volume by Accts with 100 contracts or more as a % of bracket volume
									10348	10697	83029	25.3
H (11:00-11:30)	224	1401	531	1078	1405	994	306	200	2466	3673	18374	33.4
J (11:30-12:00)	Ø	336	500	905	690	1159	Ø	120	1190	2520	16507	22.5
K (12:00-12:30	224	1389	2451	1307	2644	1944	410	Ø	5729	4640	28214	36.8
L (12:30-1:00)	221	427	1945	1414	1967	1497	340	573	4473	3911	29607	28.3
M (1:00-1:30)	645	382	2101	1579	2573	1918	717	1038	6036	4917	31608	34.7
N (1:30-2:00)	2224	484	2892	3215	3679	3989	1329	1839	10124	9527	39168	50.2
P (2:00-2:30)	210	Ø	1261	1305	2012	1801	270	221	3753	3327	19373	36.5
Q (2:30-3:00)	843	333	684	2537	1003	897	Ø	169	2530	3936	15482	41.8
R (3:00-3:30)	100	120	405	208	694	571	101	109	1300	1008	10016	23.0
TOTALS: (Without Brackets C-G)	4691	4872	12770	13548	16667	14770	3473	4269	37601	37459	208,349	

Daily Total 291,378

Source: Chicago Mercantile Exchange

Attachment 4

The CHAIRMAN. Thank you very much, Chairman Phillips. I appreciate the statement, the letter,[2] and the study, which I have placed in the record.

Not knowing just how the Senate floor schedule will go, I would like to begin by discussing Mr. Boesky's trading in the stock index futures markets during the period just before and after the time he reached a settlement with the government in what has to be described as the biggest insider trading scandal in Wall Street history.

As a preliminary matter, I think it would be helpful to clarify a couple of points. First, in the record you have compiled for the committee concerning Mr. Boesky's trading position, you have included not only information about positions held by Mr. Boesky personally, but you have also included those held by entities known by you to be owned or controlled by Mr. Boesky; is that correct?

Ms. PHILLIPS. Yes, sir. It is aggregated information.

The CHAIRMAN. And what are those companies?

Ms. PHILLIPS. Just a second. [Conferring with staff.] During the time period in question, futures positions in four accounts related to Ivan Boesky were reported to the Commission. Two accounts were reported under the name Seemala, S-e-e-m-a-l-a Corporation. Our records indicate this is a brokerage firm located in New York City, which is wholly-owned by Ivan F. Boesky Corporation. Seemala Corporation is listed as the entity that controls the trading of these two accounts.

The other two accounts are in the name of Farnsworth and Hastings Limited, an investment firm located in Hamilton, Bermuda. Commission records indicate that Ivan F. Boesky Corporation has a 10 percent or more financial interest in this firm. The precise amount is not known.

IFB Management is listed as the entity that controls the trading in these accounts.

The CHAIRMAN. So when we talk about the aggregate position Mr. Boesky held in the market, we are talking about the aggregate position of these entities as well.

Ms. PHILLIPS. Yes, sir.

The CHAIRMAN. Because of course, the suggestion has been made that between the time of the settlement and the time it was announced Mr. Boesky got a pretty special deal here, that he worked out a settlement with the SEC and then, before any announcement was made, was able to speculate a great deal in the market to the detriment of others, who in effect ended up paying for his fine.

I want to make clear that the Commission has not compiled records of individual trades, that the only information you have available to you is the positions held by Mr. Boesky at the end of the day; is that correct?

Ms. PHILLIPS. That is correct.

The CHAIRMAN. Then let us talk about the first 2 weeks in No- whether there was intraday trading by Mr. Boesky; you only know the positions at the end of the day—is that correct?

Ms. PHILLIPS. That is correct.

The CHAIRMAN. Then let us talk about the first two weeks in November, just before the announcement of Mr. Boesky's settlement.

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[2] See page 3 for the letter of the Commodity Futures Trading Commission, dated July 13, 1987.

The settlement was announced on November 14. Now the Securities and Exchange Commission has been criticized for permitting Mr. Boesky to sell off substantial blocks of stock during this period in advance of the settlement announced on November 14. Generally, what were Mr. Boesky's positions in the stock index futures markets during this period?

Ms. PHILLIPS. First of all let me say that the position information that we have submitted to the committee [3] are actually the companies' positions; so they may not be Mr. Boesky's personal positions. That disclosure does need to be made.

The CHAIRMAN. But these are companies controlled by him.

Ms. PHILLIPS. Yes, sir. But again, we do not know what were the profit arrangements he had with the particular companies. That information is not known.

Generally, he was short during most of the period you particularly cited. As I mentioned in the letter to you, if he had long stock positions, that may have been a hedge against those positions. Nevertheless, these were not positions that were in excess of the speculative limits, so he need not have disclosed that information to us nor to the exchange.

The CHAIRMAN. Well, assuming that he was unloading his equity portfolio in the stock market, does it appear to you that he was simultaneously using the futures markets to hedge against any market drop which might occur either independently or as a result of his stock transactions?

Ms. PHILLIPS. Well, it is really very difficult for me to speculate as to what his motives were because we do not have access to his stock positions, which you cited. Also, these may have been spread positions in the options market. So it is difficult to speculate as to what his motives might have been.

The CHAIRMAN. Well, let us take some of the things that we can show empirically. The announcement was made at the close of business on Friday, November 14. Now, on Monday, the market started dropping sharply. It dropped sharply the beginning of the week that followed. Was Mr. Boesky able to close out some of his short positions and take advantage of the market drop which resulted from the announcement of the insider trader settlement?

Ms. PHILLIPS. In reviewing that data, it appears that in some instances he was increasing his position, and in some places he was decreasing his position.

The CHAIRMAN. Well, was he able to take advantage of the market drop which resulted from the announcement of the insider trader settlement?

Ms. PHILLIPS. If he were net short, these positions would indicate there would be profits in those accounts, yes.

The CHAIRMAN. And is that the way it appears?

Ms. PHILLIPS. That is the way it appears, yes.

The CHAIRMAN. And it's probably the way it appeared to some of the people who had lost money as a result of some of those transactions and who felt that he may well have taken advantage of the delay of the SEC in making the announcement.

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[3] Position information is retained in the committee's file.

Ms. PHILLIPS. Of course, if these were hedge positions, they would have been offset with losses elsewhere.

The CHAIRMAN. I understand.

During this entire period of time, August through November 14, did Mr. Boesky ever exceed the specified speculation limits?

Ms. PHILLIPS. No, sir, the companies' aggregated accounts did not exceed speculative limits.

The CHAIRMAN. Would you describe his positions as substantial?

Ms. PHILLIPS. The speculative limits are fairly high in this area, but it is a very deep and liquid market, so relative to the market they were not substantial, but for an individual, yes, they may well appear substantial.

The CHAIRMAN. In fact, there were some contracts that were worth hundreds of millions of dollars, were there not?

Ms. PHILLIPS. Yes.

The CHAIRMAN. Back home in Vermont, we would call that kind of substantial.

Were these positions out of the ordinary, though, for major traders?

Ms. PHILLIPS. No, they were not.

The CHAIRMAN. Were they of a pattern which would have caused you to investigate?

Ms. PHILLIPS. No, sir.

The CHAIRMAN. When did you become aware of the SEC's investigation and settlement with Mr. Boesky?

Ms. PHILLIPS. About an hour before the settlement was announced, the SEC contacted our Division of Trading and Markets and notified us of the settlement.

The CHAIRMAN. So they were actually notifying you no quicker than they were having some typist type up their press release about the settlement.

Ms. PHILLIPS. I am not sure of their internal operations, but it was a fairly close schedule.

The CHAIRMAN. In other words, even though you are a major regulatory body, in effect, the SEC did not let you know any earlier than they let the Associated Press or UPI or the Wall Street Journal?

Ms. PHILLIPS. We had some advance notice; as I mentioned, it was about an hour.

That would be a normal practice, as a matter of fact.

The CHAIRMAN. Have you voted, Senator Harkin?

Senator HARKIN. Yes.

The CHAIRMAN. Well, if you would like to stay and ask some questions, you may. Otherwise, I am going to recess for 10 minutes.

Senator BOND. Mr. Chairman, if I could ask your indulgence, I have a meeting that I have to be at at 10:45.

The CHAIRMAN. Go ahead.

STATEMENT OF HON. CHRISTOPHER S. "KIT" BOND, A U.S. SENATOR FROM MISSOURI

Senator BOND. I merely wanted to submit for the record some questions that I would address to each of our witnesses here today. They have many important things on which to testify. It is a period

of change, and there are many, many things in which this committee is deeply interested. But I have a very particular interest in your proposal of February 14, 1987. As I understand it, the proposal will affect the Kansas City Board of Trade, the Chicago Board of Trade, and the MidAmerica Exchange.

In particular, as I understand it, there would be speculative position limits which would be higher for the Chicago Board of Trade than for the Kansas City Board of Trade. It would appear initially, at least, that this could impose some serious competitive disadvantages for the Kansas City Board of Trade.

We are also concerned about the combining of five principal grain contracts, traded at the MidAmerica Commodity Exchange and the Chicago Board of Trade and what effect that would have on the markets.

We hear that there have been significant comments received by the Commission in opposition to these proposed regulations, and I will look forward to seeing in the record your response and also reading the response to the questions we have submitted.

Again, I apologize—I have a command performance meeting that I must attend at 10:45—because I would welcome the opportunity to discuss these with you later. But I appreciate your testimony.

Mr. Chairman, I will submit these questions for the record and go vote.

Ms. PHILLIPS. We will be happy to respond to them.

[The material follows:]

Christopher S. Bond

QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY
JULY 15, 1987

Chairwoman Phillips

1. The 90 day comment period ended May 24, 1987. I understand that the Commission has been evaluating the comments since that time. What do you plan to do next, will a new proposal be put forth or will final regulations be issued?

Commissioner Hineman

1. The CFTC proposal issued February 24, 1987 attempted to increase the incentive to trade in back months. How have the comments received by the Commission responded to these provisions?

2. Why do the proposals address the problem on a market by market basis rather than a commodity by commodity by commodity basis?

3. As I understand it, there have never been any problems with the current arrangements regarding the CBT and MidAm. What is the justification for combining the five principle grain contracts traded at the two exchanges? How have the comments received by the Commission responded to this?

4. If the proposal were approved, in your judgement would MidAm be affected? Could this essentially eliminate the MidAm exchange?

5. What is the justification for increasing the speculative position limits for the CBT (soft red winter wheat) and not those of the KCBT (hard red winter wheat)? Won't this significantly impair the KCBT's ability to compete with the CBT? How have the comments received by the Commission responded to this proposal?

Commissioner Davis

1. The CFTC proposal issued February 24, 1987 attempted to increase the incentive to trade in back months. How have the comments received by the Commission responded to these provisions?

2. Why do the proposals address the problem on a market by market basis rather than a commodity by commodity by commodity basis?

Commissioner Seale

1. As I understand it, there have never been any problems with the current arrangements regarding the CBT and MidAm. What is the justification for combining the five principle grain contracts traded at the two exchanges? How have the comments received by the Commission responded to this?

2. If the proposal were approved, in your judgement would MidAm be affected? Could this essentially eliminate the MidAm exchange?

Commissioner West

1. What is the justification for increasing the speculative position limits for the CBT (soft red winter wheat) and not those of the KCBT (hard red winter wheat)? Won't this significantly impair the KCBT's ability to compete with the CBT? How have the comments received by the Commission responded to this proposal?

COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W., Washington, D.C. 20581

Kalo A. Hineman
Acting Chairman

(202) 254-6318

August 24, 1987

The Honorable Christopher S. Bond
United States Senate
SR-293 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Bond:

This letter and enclosures respond to the questions you posed to each Commissioner at the hearing July 15, 1987, before the Committee on Agriculture, Nutrition, and Forestry. I have sent a copy of these responses to the Committee staff to be included in the record as you requested.

Please note that Commissioners William E. Seale and Robert R. Davis, who received questions identical to the ones I received, wish to join me in responding to your questions.

Commissioner Fowler C. West's response and the response from former Chairman Susan M. Phillips are enclosed.

Sincerely,

Kalo A. Hineman
Acting Chairman

Enclosures

QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY
JULY 15, 1987

Q. The 90 day comment period ended May 24, 1987. I understand that the Commission has been evaluating the comments since that time. What do you plan to do next, will a new proposal be put forth or will final regulations be issued?

A. The Commission proposed amendments to federal speculative position limits on March 5, 1987 and provided a comment period through June 3, 1987. Over 75 comments were received by the Commission, some quite lengthy. Many of these comments were received by the Commission through the middle of the month of June. The Commission is in the process of reviewing the comments and evaluating modifications to the proposed rules based on those comments. Until it completes that evaluation, the Commission is unable to determine whether, under the Administrative Procedure Act, the next step should be to issue final rules or to request further comment on reissued proposed rules.

Q. The CFTC proposal issued February 24, 1987 attempted to increase the incentive to trade in back months. How have the comments received by the Commission responded to these provisions?

A. The Commission received comments from a wide range of interests including exchanges, traders, futures commission merchants, professional commodity fund managers, commercial users, and individual producers and their associations. Generally, individual agricultural producers strongly opposed an increase in speculative position limits. Associations of agricultural producers and certain commercial users supported moderate increases to the speculative position limits. Other commentors in these categories suggested technical changes to the proposed rules but did not comment on the particular levels proposed by the Commission. In contrast, the futures exchanges, futures commission merchants, professional traders, and fund managers expressed the view that the Commission's proposals did not go far enough. In general, these commentors suggested that the all-futures-combined speculative position limit be raised drastically or eliminated altogether.

Q. Why do the proposals address the problem on a market by market basis rather than a commodity by commodity basis?

A. In proposing these revisions to the federal speculative position limits, the Commission noted that after reviewing the volume and distribution of speculative position sizes for various markets, it appeared that there were vast differences among the contracts for the same or similar commodities. The Commission concluded that in light of

these large differences in the amount of trading activity, setting a single limit for all contracts trading in a similar commodity could result in a speculative position limit which was either too low for certain markets or far higher than other markets could support on their own merits or could likely absorb. Thus, the Commission determined that a more tailored approach, based on determining speculative position limit levels on the trading activity in each contract market, appeared a more reasoned approach.

Q. As I understand it, there have never been any problems with the current arrangements regarding the CBT and MidAm. What is the justification for combining the five principle grain contracts traded at the two exchanges? How have the comments received by the Commission responded to this?

A. In proposing these rule amendments, the Commission recognized that there have not been specific problems caused by the current levels applied to the Chicago Board of Trade ("CBT") and MidAmerica Commodity Exchange ("MidAm"). The Commission explained in the Federal Register notice that "where contracts are virtually identical, separate speculative position limits have the effect of multiplying the speculative position limit in a contract by the number of separate but identical contracts." This did not present a problem in the past because current speculative position limits are relatively low. The potential impact of raising

the speculative position limits raised the concern that cumulating such limits might become necessary. Accordingly, the Commission asked for particular comment on the advisability of cumulating speculative positions in this manner.

Except for comments received from certain commercial users and individual producers, which are almost uniformly against an increase in speculative position limits, the remaining commentors opposed cumulating speculative position limits for identical contracts. In general, commentors reasoned that cumulating such limits would drain liquidity from the MidAmerica Commodity Exchange. The Commission is reviewing these comments in light of data pertaining to the incidence of large traders' holding positions on both exchanges.

Q. If the proposal were approved, in your judgement would MidAm be affected? Could this essentially eliminate the MidAm exchange?

A. In proposing this rule, the Commission believed that if adopted, the rule would not have a deletorious effect on either the CBT or the MidAm. Because speculative position limits generally were proposed to be raised, except for positions in the spot month, the Commission reasoned that traders would be able to hold all or part of their positions on either contract market. In light of the generally higher

proposed limits, the Commission reasoned that there should be no loss of liquidity on either exchange. Moreover, the Commission analyzed data concerning positions held by speculative traders and found that, historically, few, if any, would have been affected adversely from cumulating positions if the limits were raised as proposed. Accordingly, the Commission does not believe that this proposal would essentially eliminate the MidAm exchange. Of course, the Commission is reconsidering this aspect of the proposed rules in light of the comments received.

Q. What is the justification for increasing the speculative position limits for the CBT (soft red winter wheat) and not those of the KCBT (hard red winter wheat)? Won't this significantly impair the KCBT's ability to compete with the CBT? How have the comments received by the Commission responded to this proposal?

A. As discussed previously, the proposal to set speculative position limits on a market-by-market basis was based on data indicating existing differences in the size of the markets and in the distributions of speculative traders. In considering the Kansas City Board of Trade ("KCBT") and CBT contracts on their individual merits, data indicated a substantially higher level of open contracts on the Chicago exchange. In addition, the data showed that although some traders were constrained on the KCBT, significantly more

speculators were constrained by the current speculative position limits on the CBT contract market. The Commission believed that the KCBT's ability to compete with the CBT would not be impaired significantly by the proposal in light of the fact that far fewer of those trading in the KCBT are currently constrained by the present limits. Accordingly, the Commission reasoned that the growth potential of the KCBT would be unaffected by the proposed rules.

With the exception of agricultural producers who opposed all increases in speculative position limits, those commenting generally opposed differing levels for the CBT and KCBT. Indeed, many of those commenting supported parity among the speculative position limits for three wheat contracts--those of the CBT, KCBT, and Minneapolis Grain Exchange ("MGE"). The commentors reasoned that rather than analyzing the need to increase speculative position limits for each market based on the historical distribution of traders, equivalent levels would aid the KCBT and MGE in attracting professionally managed speculative funds. These commentors reasoned that in the absence of higher limits, professionally managed speculative funds would not trade on the KCBT or MGE markets because their lower speculative position limits would make them unattractive. The Commission is evaluating those comments at this time.

Response from Commissioner Fowler C. West:

Question. What is the justification for increasing the speculative position limits for the CBT (soft red winter wheat) and not those of the KCBT (hard red winter wheat)? Won't this significantly impair the KCBT's ability to compete with the CBT? How have the comments received by the Commission responded to this proposal?

Answer. The proposal to set speculative position limits on a market-by-market basis was based on existing differences in the size of the markets and in the distributions of speculative traders. In considering the Kansas City Board of Trade ("KCBT") and CBT contracts on their individual merits, data indicated a substantially higher level of open contracts on the Chicago exchange. In addition, the data showed that although some traders were constrained on the KCBT, significantly more speculators were constrained by the current speculative position limits on the CBT contract market.

With the exception of some agricultural producers who opposed all increases in speculative position limits, those commenting generally opposed differing levels for the CBT and KCBT. Indeed, many of those commenting supported parity among speculative position limits for the three wheat contracts---those of the CBT, KCBT and Minneapolis Grain Exchange ("MGE"). The commentors reasoned that rather than analyzing the need to increase speculative position limits for each market based on the historical distribution of traders, equivalent levels would aid the KCBT and MGE in attracting professionally managed funds.

I personally think these comments are pertinent and helpful, and that is the purpose of the comment period. I strongly feel we must develop a final rule that will not disadvantage any exchange dealing in similar commodities. Exchanges are well on the way to implementing better audit trails making the policing of these rules much more effective. As a result, we can respond with a more flexible approach to the speculative limit issue, and we should.

Senator HARKIN [presiding]. On the instructions of the Chairman, the committee will stand in recess for approximately 10 minutes.

[Brief recess.]

The CHAIRMAN. I apologize for the interruption.

Let me ask you, Madame Chairman, were you ever asked by the SEC to monitor Mr. Boesky's activities in the futures markets between August and November 14, 1986?

Ms. PHILLIPS. No, sir.

The CHAIRMAN. Would the SEC have had any way of tracking Mr. Boesky's activities in the futures market independent of working with your Commission?

Ms. PHILLIPS. No, sir.

The CHAIRMAN. Are you aware of whether the SEC knew of Mr. Boesky's activities in the futures market?

Ms. PHILLIPS. I do not know whether they were aware of that or not; they may have been.

The CHAIRMAN. But the SEC would not routinely have access to stock index futures positions, would they?

Ms. PHILLIPS. They can certainly ask us. They can ask the CFTC, and they can also ask Mr. Boesky. So they would have those two sources of information.

The CHAIRMAN. But they did not ask you, and you have no knowledge that they asked Mr. Boesky.

Ms. PHILLIPS. I have no idea whether they asked Mr. Boesky.

The CHAIRMAN. But they did not ask you.

Ms. PHILLIPS. They did not ask us.

The CHAIRMAN. Were Mr. Boesky's positions discussed at the CFTC's surveillance meetings during September or early November?

Ms. PHILLIPS. No, sir.

The CHAIRMAN. Now, what about after the announcement that the settlement was made November 14; did the Commission staff at that time look at Mr. Boesky's positions from an enforcement standpoint?

Ms. PHILLIPS. From an enforcement standpoint, no, sir, we did not.

The CHAIRMAN. Why is that?

Ms. PHILLIPS. Our staff, of course, those who were notified by the SEC of the pending announcement, did look at whether or not there were any capital implications for any of the firms that Mr. Boesky was related to. There were no capital implications. So we did not have a concern from the standpoint of market integrity in the futures market. And in the course of that, we certainly were able to find out what his positions were.

The CHAIRMAN. Well, if you had known that Mr. Boesky had settled with the SEC on insider trading charges, would that have indicated a reason to more closely monitor his positions in the futures markets?

Ms. PHILLIPS. Not necessarily, no, sir.

The CHAIRMAN. Even though he could have been using that interval between the time of the settlement and the time of the announcement, not making too fine a point of it, to be able to raise the money to pay his fine?

Ms. PHILLIPS. It is not a violation of the Commodity Exchange Act to maintain these positions. Certainly the Securities and Exchange Commission could have and may have taken that into consideration with respect to the settlement. I do not know that. They were certainly looking at a variety of his assets.

The CHAIRMAN. In your statement, you say, "Since the futures and options markets have proven to be so valuable to the securities industry, the Commission has worked closely with the SEC and with futures and securities exchanges to examine and develop appropriate, coordinated regulatory responses to these perceived problems"—meaning program trading. "We believe these joint endeavors have been productive and the level of cooperation and coordination among the securities and futures regulators has been excellent."

Would you consider this a case of cooperation and close coordination between the securities and futures regulators?

Ms. PHILLIPS. The areas in which we have concentrated have been areas in which there have been major market moves, so we have been looking from a marketwide perspective.

I would also say that we have cooperated with the SEC in other enforcement kinds of actions where either our Commission or the SEC deems that such cooperation is appropriate.

The CHAIRMAN. I am not so concerned about your cooperation. I am a little bit concerned about the SEC's cooperation at this point.

Ms. PHILLIPS. Well, of course, they were investigating violations of the securities laws and the securities regulations, and so that would be their determination as to whether or not they should seek our cooperation in that endeavor. And they certainly could do so.

My understanding is that this was not a concern to them at the time.

The CHAIRMAN. Well, I have always held the view that stock index futures are immune to insider trading because information about one company or one stock is unlikely to have a major impact on the stock market. If you are dealing with the stock index futures, you know, IBM moves a little bit, and then something else does—that by itself is not going to make a major difference. But what about information that is not available to the public which is certain to move the index itself, even if it is not clear how it would move individual stocks—for example, the announcement of Boesky's settlement. That is something that one would guess will have an effect. Or to use a hypothetical situation, let us use the announcement of the insolvency or impending insolvency of a major brokerage house. Do you believe there is a need to stop individuals from taking advantage of such information and taking advantage of the general public, who do not have access to this information, even when we know that once that information becomes public, it could move the whole index?

Ms. PHILLIPS. First of all, let me say that when the announcement was made, the markets were closed, and the SEC, I think, did take that into consideration, which would routinely be done; it was done on a Friday afternoon. So there was a period of time during which the market could, quote, "absorb".

On any market move, it may be very difficult to speculate as to what were the specific reasons the market moved earlier the next

week, and I am not sure that I would be able to attribute that to the announcement. Some news reports have so attributed it, but I am not sure that you could separate it out.

From the Commission's perspective, if we were to have information about a major announcement that would have market impact, we would—and in fact, in this instance, did—contact the relevant exchanges, particularly with respect to potential capital considerations. So there was coordination with the relevant futures exchanges about that settlement, and would normally be so were we to get information about a major market move in any market, be it the stock index market or an agricultural market.

The CHAIRMAN. But you almost have to assume in a case like this, even though the announcement is made on Friday and you have the weekend to absorb it, that when people realized that the settlement had been reached with Mr. Boesky, he was then given a fairly considerable amount of time before the public announcement was made to continue speculating both in the commodity and stock markets; that when people realized that he had been able to take advantage of a major piece of Wall Street news that nobody else had during that time, that it will have some effect on the market.

Ms. PHILLIPS. I am sorry. I really cannot say that. Many things that happened over the weekend also may have had a market effect.

The CHAIRMAN. I understand. Well, one last question, then. Can you tell from the documents before you how much money Mr. Boesky made or lost in the futures market just prior to or just after the announcement of his settlement with the Government?

Ms. PHILLIPS. No, sir, we really cannot. Because the trading was for several accounts, we could not make that kind of calculation without having access to the information as to when he specifically put on the positions, what prices he executed at, what were his commissions, and so on.

The CHAIRMAN. But with that information, you would be able to?

Ms. PHILLIPS. Certainly, if you launched a certain kind of investigation to make that profit calculation, or asked Mr. Boesky directly. But we had no reason to make that kind of calculation.

The CHAIRMAN. Nor am I suggesting that you did, but let me ask you this: do you know whether the SEC made such an inquiry?

Ms. PHILLIPS. I do not know.

The CHAIRMAN. Would they be able to under their rules and regulations?

Ms. PHILLIPS. I am not as familiar with their standards as I am ours, sir.

The CHAIRMAN. Thank you very much. I have further questions, but our distinguished ranking member, Senator Lugar, is here, and I want to yield to him and then to Senator Melcher.

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA

Senator LUGAR. Thank you very much, Mr. Chairman.

I apologize to the Commission for my inability to attend the beginning of the meeting. I would have greeted you all warmly and especially congratulated Chairman Phillips on a remarkable tenure

which I think has been most constructive for the Commission and for Americans, that she and all of you have served so well.

Let me follow up on the chairman's questioning from another point of view. I have read the news accounts, and so I have no more knowledge than has come from this hearing about what occurred with Ivan Boesky and his settlement. But as I retrace steps of what I think occurred, those who were attempting to prosecute him, or at least investigate him prior to prosecution, decided, as you said, Chairman Phillips, that the implications of his sales or rapid liquidation in the market, might have an effect, apparently. Would you agree that this is one reason, at least, that he was allowed to make sales of securities for various accounts prior to an announcement of the legal difficulties that he was in?

Ms. PHILLIPS. I must say that my knowledge is really confined to some of the press reports also, and that is my understanding, that the SEC was concerned particularly about his stock portfolio.

Senator LUGAR. So he proceeded with those sales. And as I recall, the Chairman of the SEC was criticized at some length later on by those who always can second-guess, but who in good faith were saying, "Why did you allow him to do that?" And as I recall, the response of the Chairman, Mr. Shad, was essentially that, taking a look at the overall picture, the SEC felt that it would be healthier for working markets if somehow these sales occurred without the announcement intervening.

For example, the announcement could have come on a Friday, and the sales had not been made, and an order that he dispose of these securities come, and I would gather the SEC felt from Mr. Shad's testimony that it was a healthier situation for the markets.

Now, the reason I make this point is that it would appear to some analysts—and we are all now in that sort of a project, of trying to describe why markets do what they do—but to some analysts over that weekend, they took a look at the situation of Mr. Boesky and said there are going to be very great changes in the arbitrage market situation. Those persons who have been dealing in arbitrage stocks, who have been trying to predict where these mergers may occur, or takeovers, or what-have-you, now will face a new ball game. It had what some would call a chilling effect upon activities, so that many persons, the so-called "high fliers" in the markets, were bound to suffer a hit of sorts because activities in some of those stocks, by some of the persons who have been very active in that, might have been curtailed, at least temporarily, as people surveyed the scene after the announcement for Mr. Boesky.

As I recall, November 17 and 18 are the dates that seem to be in question, on which the Dow Jones went down 56 points—many people said that is an institutional change in a way. People are going to be dealing with the market in a different way.

What I suppose I find interesting is that there seems to be mixed accounts as to Mr. Boesky's motivation. There seems to be in the Washington Post story some evidence that earlier in September, he had been in the futures market and made a profit on the decline of the Dow Jones on a particular day, so he was obviously familiar with those markets, as a sophisticated investor might be.

But having come into the market on the 17th and 18th, at least some suggest that he was attempting to hedge and to at least try to

offset losses that he saw, I suppose, from a further disposal problem. It is hard to tell what was the motivation.

The thing I find interesting is that essentially, the markets worked. The SEC knew that there was a problem and therefore asked Mr. Boesky to dispose of stocks unknown to the public. So the New York Stock Exchange, for example, would not have been hit by the same problems. The problems that CFTC looks at were in markets that came after the announcement and without knowledge that Mr. Boesky was operating in those markets. Apparently, he could do so, at least, without stopping him for a few days' time. And even with all of the knowledge that had come from the weekend, all of the phobias about arbitrage, there was enough resilience, apparently, in the futures markets, that they absorbed whatever Mr. Boesky was doing plus the fallout, the oscillations, that grow larger from speculations in the New York Stock Exchange. And it is really only now that in retrospect we are going back to see, really, what happened. But it was not apparent at that time, I gather, that the futures markets were under great stress. And what we are looking at is more of an ethical problem of whether somebody who has been targeted by the SEC, who has been asked to dispose of his entire portfolio, ought to untrammeled, run into the futures markets, which do not have a clue at the moment that is where he is, and sort of continue his trading.

Is it possible that if the SEC, for instance, gets into these cases again such as that of Mr. Boesky, that it might ask for a court order or for whatever legal means are required, that would cover futures trading, also? Was it perhaps a mistake on the part of the persons who were trying to stop Mr. Boesky's trading, and thought they had stopped it all, and thought they had liquidated the whole position so it would not have an effect on the markets? They just did not go far enough. Do you have any comment about that kind of order?

Ms. PHILLIPS. Well, there are several things. I do recall all of the articles that were concerned about a restructuring of securities market regulation which may have had a chilling effect. But that may have been one of a number of kinds of effects to be absorbed over the weekend.

Of course, our concern, as you point out, is whether or not the futures markets are performing properly, that is to say, whether or not that price in the futures market is accurately reflecting the forces of supply and demand. And so we would be concerned about the relationship between the stock price and the futures price. So to that extent, of course, we were monitoring that particular situation, and the markets were performing appropriately during that period.

With respect to your specific question, as you may recall, in 1982 we did ask for a change to the Commodity Exchange Act which would allow us to share position information with other enforcement agencies for law enforcement purposes. So had the SEC been concerned about these positions—and it is very possible that they knew about the positions and were not concerned as to the size of them; I do not know that—but they certainly could ask us, and we would be pleased to work with them and certainly share that information with them as to what his positions were.

Senator LUGAR. And the law in 1982 gave you the authority that you requested? That is my recollection.

Ms. PHILLIPS. Yes, sir. The Congress made that change, and we have in fact subsequently worked with the SEC on some enforcement cases, as we have with some of the State authorities.

Actually, I think in 1982, the emphasis was more on working with the States, but it was also all Federal and State agencies for which we requested that legislation, and it has been a very useful change to the act.

Senator LUGAR. But on this occasion, I think you testified in answer to the chairman's question, you were not approached by the SEC.

Ms. PHILLIPS. Not with respect to this particular matter for enforcement purposes. They did notify us with respect to the announcement for capital purposes, and we did initiate inquiries as to the capital effect of the settlement and determined that there would not be a significant capital effect on any of the firms; and we were in contact with the relevant futures exchanges.

Senator LUGAR. But now, SEC did not ban Mr. Boesky from going into the futures markets?

Ms. PHILLIPS. No, sir, they did not.

Senator LUGAR. So he could have gone out, and apparently did the next Monday. Leaving aside positions that he had, when SEC talked to you about his general case, he could have initiated new positions on Monday and Tuesday.

Ms. PHILLIPS. He could have, although that does not appear to be the case.

Senator LUGAR. I see. In other words, the positions we are talking about were ones that were already established as opposed to new trading.

Ms. PHILLIPS. Yes, sir.

Senator LUGAR. In other words, Mr. Boesky did not, as far as we know, go out after the weekend and say, "Look what is occurring. There is general confusion in the arbitrage markets, and I am going to profit on that," and sort of set up a whole new set of trades on Monday and Tuesday.

Ms. PHILLIPS. Around that period, his positions were fluctuating very slightly, but there was not significant buying or selling.

Senator LUGAR. On Monday and Tuesday afterward?

Ms. PHILLIPS. That is correct.

Mr. SEALE. Senator, may I interject myself? Senator Lugar, Monday and Tuesday would have been too late, because the announcement was made on Friday. If he were going to profiteer, he would have had to have done it essentially by increasing the short position at the end of the preceding week—before the announcement.

But if I might put it in perspective for just a minute, what we are dealing with, we are dealing with generalities. You have the data, and we have the data before us. But so that we understand what we are seeing here, from the aggregate data before us, there is no indication that Mr. Boesky somehow wildly profiteered from this announcement. He had a position on, he liquidated part of that position—a fairly small part of that position—on the following Monday. The position was a short position.

But certainly, if Mr. Boesky—again based on the data that we see before us—wanted to somehow illegitimately profiteer from futures positions, he needs somebody to give him lessons, because he did not do it here, and he did it wrong because he begins reducing the position in the days preceding the announcement of the settlement. And if he knew the market was going to go down, that would be the wrong thing to do.

Senator LUGAR. He reduced his position in the days before the settlement?

Mr. SEALE. From the data before us, he substantially reduced his position in the S&P 500 commencing close of business on the 11th. In fact he substantially reduced his position in the New York Stock Exchange composite commencing back in the middle of October.

There is no indication, again from the data that you see before you, that there is some kind of incredible profiteering. I mean, the evidence is not there.

Senator LUGAR. Now, you are a professional, and you understand the trading, but just underline, I suppose, the obvious. If a person believes that the market is going to go down, he would not be reducing a short position; isn't that correct?

Mr. SEALE. I am sorry, Senator.

Senator LUGAR. If an investor believes that the stock market is going to go down, he would not be reducing a short position in the futures market?

Mr. SEALE. That is correct. He would hold that short position and liquidate it after the market went down.

Senator LUGAR. Yes. So in any event, Mr. Boesky was reducing his short position, and even in the week in which the settlement was being reached, in which you would have liquidated everything, which might have had a very downtrend effect, he was still reducing his short position even in that week.

Mr. SEALE. He was reducing his short position in one of the indexes, even during the week of the announcement. The other was being held constant.

Senator LUGAR. Now, try to help me. Why would Mr. Boesky make trades of that variety? Can you give us any idea of the insight of an investor?

Mr. SEALE. You know, as an economist, I am always willing to give you my opinion, which probably is incorrect more times, certainly, than it would be correct. But the belief I think one might come to is that he had some kind of a portfolio; that in fact he had hedged with these indexes, and in fact was liquidating the portfolio and liquidating his short hedge position.

That would be the obvious suggestion. But again, if you are looking at the data before you and you ask is this man going to profiteer by tens of millions of dollars, he did not do the rational profiteering thing on the 17th and 18th, which would have been to liquidate the position when the Dow was down 56 points.

Senator LUGAR. Still, our problem, though, even if Mr. Boesky did not do the things that he might have done to maximize profit, the question, I suppose, is still the idea that the SEC might have shared this information on what was happening in Mr. Boesky's case with the CFTC, so that there was greater coordination of the

two bodies, given the fact that both have markets that somehow intersect in this situation.

Mr. SEALE. Senator, I totally agree.

Senator LUGAR. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

I would just note one thing. If you take his New York Stock Exchange composite, it remained exactly the same from October 19, 1986, straight through November 14, the day of the announcement, and then dropped very, very substantially on Monday the 17th. So at least in that particular instance, he was not selling prior to the announcement. He maintained precisely the same position for over a couple of weeks and then dropped it considerably the Monday after the announcement and continued to drop it considerably thereafter.

But the point, of course, remains, as Senator Lugar has just pointed out—is there cause for concern in that the SEC did not coordinate with you in this matter and treated this whole thing as though there were only one area of concern with Mr. Boesky, those areas that come under their jurisdiction. Whether adroit or inept, Mr. Boesky still had another major area of trading to do and one that could well be affected by the timing of the settlement—questions that I intend to ask the SEC. In fact, questions I intend to ask Mr. Boesky because I am concerned and somewhat disturbed that the SEC dealt with this as though the only involvement in the financial markets that Mr. Boesky might have would have been those under their jurisdiction, without looking at the very substantial markets under your jurisdiction, and that this was something they should have been coordinating with you.

I would also suggest that one of the things that may have caused concern in the markets was not just the financial dealings of Mr. Boesky, or what he might or might not have speculated in; but, without appearing cynical, the announcement that he had been carrying a tape recorder during a lot of meetings leading up to his liquidation—he was wired for sound. It is possible—and I mean this as no denigration of thousands of very hardworking and honest people—but there might have been a couple of people with whom he spoke during that time who may have had at least small twinges of conscience as they quickly looked up the telephone number of their lawyer on their Roladex.

I yield to Senator Melcher.

Senator MELCHER. I hope it does not disappoint anybody if I do not pursue Boesky, but I want to get back to some of the nuts and bolts that have to go into making the CFTC work properly.

As you recall, Madam Chairman, we had several discussions on the questions of audit trail. That goes to the very point of whether or not we can regulate the exchanges and whether the public has confidence in that regulation of the exchanges. And I note that the audit trail that the CFTC now requires seems to be working and seems to be practical to provide good auditing and still do it quickly and across-the-board, so the public has confidence in that particular procedure of the Commission.

I am not going to ask any questions on that, but just to note it.

Second, on the matter of the sale of foreign futures to U.S. customers, I have two points that I wish to ask you to respond to. It is

my understanding that the Commission will have regulations ready by July 23; is that correct?

Ms. PHILLIPS. The staff will be making a recommendation to the Commission for consideration on July 23.

Senator MELCHER. All right. Then, the two points that I have some concern with and want your response on, are first of all, the point on this comparability of regulations, substantially the same regulations that would be applied on foreign exchanges. Is that what the proposed regulations are going to attempt to do?

Ms. PHILLIPS. The regulations are intended to comport with the extent of our jurisdiction; of course, our jurisdiction being limited to over U.S. exchanges.

To the extent we can, we are attempting to see that the offer and sale of foreign futures contracts in this country are subject to a substantially similar regulatory system as possible. So that is the intent.

Senator MELCHER. Well, I think the point of my questions go to whether or not the 1982 law that sets this in motion is going to jeopardize adversely or have an adverse effect on our own markets here; and how can the Commission, given the question of what the political climate is, what the enforcement procedures are, what the procedures are in a foreign country, how can the Commission do much about that, and how will you attempt to do something about it?

Ms. PHILLIPS. First of all, let me say that foreign futures are trading in this country now without a regulatory structure, except for being subject to our antifraud rule. The Commission intends to put into place a regulatory system that will strengthen the regulatory environment in which foreign futures are traded. Foreign options, on the other hand, are completely banned. The intent would be to put into place a regulatory system where none exists currently and give consideration to lifting the option ban so that trading can occur in a regulated environment on a market-by-market basis.

So I think, to the extent that futures are trading in an unregulated environment now, it would seem that to the extent regulations are put into place, those regulations certainly should not put U.S. exchanges at any disadvantage. We certainly recognize that U.S. exchanges probably are the most active in the world, so they have not suffered certainly, even though there has not been regulation of foreign futures in this country to date.

Senator MELCHER. The second point I wanted to raise with you regarding this matter is the definition of customer. Is the definition of customer going to be the same as it would be here in the United States, plus citizens who are buying on our own exchanges?

Ms. PHILLIPS. Yes, sir, essentially, it would be. Under the original proposed rules, I think what you are referring to is that within the definition of customer, there was a proposal to exclude the commercials. There would have been a commercial exception.

The staff is considering deleting that from the definition of customer. So in that situation, any persons trading in foreign futures would be subject to the regulatory scheme.

Senator MELCHER. Well, the third point I want to raise with you, Madam Chairman, is simply the matter of leverage trading. When we had the reauthorization bill before us, we allowed what may or

may not be a temporary continuance of leverage trading. But what can we look forward to with regard to getting all trading on designated exchanges with more oversight under CFTC?

Ms. PHILLIPS. Yes, sir. The act that was passed in 1986 did require the Commission to keep the current moratorium in place with respect to the new entrance of leverage participants, but to survey generally the industry and to try to determine what kind of interest there might be in new entrants into the leverage area.

We have initiated a survey with the assistance of the National Futures Association, and CFTC and NFA have been working jointly on that survey. It has been mailed out. Responses are now being received.

NFA has agreed to compile the results of that survey and would forward those to the Commission. We expect to get the results of the survey either later this summer or early fall. Following the results of the survey, we will propose potential changes to our leverage regulatory system, if any are appropriate. If there are not a lot of people who are interested in getting in the leverage area, it is very possible that few changes would be necessary. If there are a lot of people who are interested, then there may be significant changes that would be proposed. This would go through our comment process and once final regulations would be prepared, we would be submitting a report to the Congress that would make recommendations with respect to the changes in the regulations, the findings of the results of the survey—which include, incidentally, a question with respect to the economic utility of these contracts. We would submit that to Congress, and there would be a layover period during which, if Congress so desired, they could consider the issue.

Were there no change in the law, however, leverage would be feasibly opened up following that layover period.

Senator MELCHER. That series of events would transpire about a year from now?

Ms. PHILLIPS. This coming year. The deadline for submission to Congress is the fall of 1988.

Senator MELCHER. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

I am going to have to leave shortly, but I should note that I am going to submit for the record a number of questions on foreign futures and off-exchange instruments, as well as the questions we have raised so far on insider trading. I think that foreign futures is an important area. Senator Melcher has touched on that, and I will make sure that my questions are not redundant about this significant area; I know you are spending a lot of time and showing a lot of concern over it.

We are concerned, too, on the committee, and we want to watch what happens. The off-exchange instrument is another area we will be looking into and we will submit questions for the record.

[Questions submitted by Chairman Leahy and responses thereto follow:]

FOREIGN FUTURES

1. Certainly the most controversial part of the CFTC's proposal involves permitting foreign options to be sold in the U.S. Congress remembers all too well the bucket shops and scam operators who were selling London Options to U.S. citizens in the late 1970s leaving a trail of customer complaints which were largely not satisfied. The CFTC was spending most of their enforcement budget trying to close down several of the firms involved. The CFTC subsequently banned the sale of London Options. How is the Commission going to prevent this type of problem from occurring again? Is there a reason to set up an option pilot program for the sale of foreign options similar to the pilot program for domestic option contracts?

2. The CFTC's proposed rules established a complex system for segregating foreign futures customers funds from U.S. futures customer funds. Some commentators estimated that the systems changes required for U.S. brokerage houses to implement the proposals would run into millions of dollars. In addition, the larger brokerage houses who do business in several foreign countries would be forced to set up equally expensive systems to comply with other countries' segregation

requirements. How is the Commission going to respond to these comments?

3. The Commission in its proposed rules provided for the registration of firms who sell foreign futures and options to U.S. customers. The commission also proposed exception or alternatives to registration. Will the Commission have a "commercial exemption" in its final rules which will exempt those firms who only solicit U.S. customers who are "commercials" (persons who use foreign futures and options in connection with their business)?

4. Another exemption provided for in the proposed rules was the "country exemption" whereby if the Commission determined that a country had a regulatory structure in place equal to our own they could grant an exemption to individuals and firms from that country. In the final rules will the Commission provide for this "country exemption"?

5. If so, would you clarify what standards you would use to make a determination whether or not a foreign country's regulation standards are comparable to ours?

6. How will the Commission grant this exemption? In other words will the staff or the Commissioners make the final determination?

7. Would a request for a foreign exemption be published for comment in the Federal Register?

8. Recently you were quoted in the press as saying that you favored a global regulator for futures. Was that a fair quote?

OFF-EXCHANGE INSTRUMENTS

1. Congress has mandated that all futures contracts must be traded on a Commission designated exchange. Yet there has been a rapid growth of new off-exchange instruments that look an awful lot like futures contracts. Does the Commission have any kind of an on-going program to review these off-exchange instruments to enforce the exchange trading requirement?

2. Apparently there has been rapid growth of these off-exchange instruments which raises concerns of many regarding fraud in the marketing of such instruments. Have any of the state regulatory agencies or law enforcement bodies expressed any concerns over these

off-exchange instruments and how they are retailed in their states?

3. What do you think are the factors that are encouraging this growth in this area? (Off-exchange)

4. Do you see any possibility of some of these hybrid instruments being subject to both securities and commodities regulation?

5. When a particular instrument is reviewed how is a determination made or what criteria is used to decide whether or not to regulate such instrument? In other words, how do you determine if an instrument if a futures contract or an off-exchange instrument having characteristics of a futures contract or option?

6. Do you or any of your fellow Commissioners feel that these instruments are forced off-exchange because of a too stringent regulatory burden, such as speculative position limits or the hedging definition?

7. Do you see any circumstances that exist or might arise in the future when the Commission believes it could waive the exchange-trading requirement?

8. Do you feel the Commission should be involved in the regulation of these off-exchange instruments and to what extent?

9. One final question, with respect to the leverage survey mentioned in your written statement: Would the Commission be in a position of coming forward with its recommendation prior to the November, 1988 deadline? What kind of changes in the current rules do you foresee?

PROGRAM TRADING QUESTIONS

1. You have presented this Committee with a Review of Stock Index Futures Trading on January 23, 1987, relating to the activities in the stock and futures markets on that day. The report's basic conclusion is that the price drop of 44 points in the Dow Jones average on that day appears to have been a correction to a rapidly rising stock market earlier that day and during the prior three weeks. In all the Dow had a swing of 115 points, or more than 6 percent, in a little over 70 minutes on January 23 and that appears at least to me to be a fairly significant move in a little over an hour. Even though a correction was warranted and appears to be the

cause of the drop do you think "program trading" caused an increase in the size of the correction once it started?

2. Looking at the opposite possibility on January 23, is it possible that rather than causing an increase in the size of the correction on that day that these stock-index futures might very well have had a stabilizing effect on the stock market by relieving some of the selling pressure?

3. Your study of trading activity on that day indicates that at that time the stock volume reached a record high on January 23. Is there any way to determine or estimate what percent of stock volume would be attributed to futures trading using some system of program trading?

4. Has anything come out of the various studies, including your January 23 review of trading, conducted by your agency or the SEC or any other agency that raises your concerns about program trading or the ultimate effects it might have on our equity markets?

5. Do you see a continued increase in the volume of stock index futures and if so, do you see any problems arising

in the ability to handle this increased volume if it does continue?

6. Do you share any of the concerns expressed by John Phelan regarding his "Financial Meltdown" theory whereby the use of program trading in stock-index futures will someday result in a cascading downturn in the stock market? (Portfolio Insurance)

7. Do you see an increase in different types of users, such as more banks or financial institutions that are not presently using these stock-index futures?

8. Do you feel comfortable with the regulations presently in place governing program trading and the systems in place governing the expiration days and if not, what changes would you recommend?

OTHER QUESTIONS

1. Your written statement refers to the implementation of the Exchange audit trail system and that beginning July 1, the exchanges systems, with the exception of the Coffee, Sugar and Cocoa Exchange, all had to be in place. Have all the exchanges implemented these audit

trail systems? Have the results, if known, been satisfactory? Have you received or heard any comments regarding the benefits or problems in utilizing these audit trail systems from the Exchanges?

2. In your written statement you refer to published rules establishing guidelines for those transactions in actual commodities and in futures in which Commission members and employees now may engage. Would you elaborate on what is presently allowed in commodities (futures and cash), by members and employees of the Commission?

3. The Chicago Board of Trade submitted proposed rules to the Commission in both the hedging and the aggregation areas. Approximately one month after the Board's rule proposals were submitted to the commission, the proposals were remitted as not accepted for filing. Without commenting on the adequacy of the proposal wouldn't it be a more appropriate approach under section 5 of the Commodity Exchange Act to begin formal consideration of the rules change proposal and inform the submitter of the additional information which would be necessary to have the change approved by the Commission?

4. The Commission is currently considering revisions of speculative position limits in the agricultural

markets. When do you aniticipate issuing final rules amending the speculative position limits?

5. Would you agree that raising the speculative position limits will add liquidity to the markets?

6. Will the Commission simultaneously consider changes in the hedging definition and aggregation rule?

7. Will an increase in the speculative position limits and changes in the aggregation rule help individual investors participate in the futures market through managed accounts?

8. Do you agree that overly restrictive speculative position limits and aggregation rules could have an adverse effect on the competitiveness of U.S. markets?

9. On November 13, 1986, the CFTC requested public comment on a petition filed January 31, 1986, by the Intermarket Clearing Corporation which would permit the cross-margining of positions in commodity futures, commodity options and securities options relating to the same underlying stock indices, foreign currencies and government securities. What progress has the CFTC made in considering these issues and do you have an anticipated time frame for final action on the petition?

FOREIGN FUTURES

1. Question. Certainly the most controversial part of the CFTC's proposal involves permitting foreign options to be sold in the U.S. Congress remembers all too well the bucket shops and scam operators who were selling London Options to U.S. citizens in the late 1970's leaving a trail of customer complaints which were largely not satisfied. The CFTC was spending most of their enforcement budget trying to close down several of the firms involved. The CFTC subsequently banned the sale of London Options. How is the Commission going to prevent this type of problem from occurring again? Is there a reason to set up an option pilot program for the sale of foreign options similar to the pilot program for domestic option contracts?

Answer. The so-called "London options" scandal which occurred during the mid to late 70's was essentially confined to scam artists operating in the U.S. The problem, however, was exacerbated by the inability of the Commission, other regulators and customers to confirm whether transactions were actually taking place in London. The final rules governing foreign options, which the Commission has approved, will permit the ban on foreign options to be lifted pursuant to Commission order on a market-by-market and product-by-product basis. Specifically, in determining whether to issue an order approving the sale of a particular foreign option product, the Commission will take into account the accessibility to regulators and customers of transactionrelated information, which was not readily available during the 70's, as well as the willingness of the National Futures Association or the relevant exchange to undertake, or arrange for the fulfillment, of sales practice compliance responsibilities with respect to the sale of such options.

2. Question. The CFTC's proposed rules established a complex system for segregating foreign futures customer funds from U.S. futures customer funds. Some commenters estimated that the systems changes required for U.S. brokerage houses to implement the proposals would run into millions of dollars. In addition, the larger brokerage houses who do business in several foreign countries would be forced to set up equally expensive systems to comply with other countries' segregation requirements. How is the Commission going to respond to these comments?

Answer. The Commission was particularly sensitive to the concerns of the brokerage community that a separate segregation requirement would create numerous accounting complexities. In that regard, the staff proposed to eliminate the separate segregation requirement for foreign futures and options customers funds. Instead, the proposed final rules take a more flexible approach to ensuring the protection of customer funds by requiring the creation of one or more regulated accounts in which the firm must make a "security deposit" in the amount of all obligations to customers in respect of foreign futures and options products. Such account or accounts may be maintained in specified depositories outside the U.S. and commingled with the funds of non-U.S. customers of the firm. Although different from a separate segregation requirement, these provisions, like existing segregation provisions, are intended to accord protection to customer funds in bankruptcy and to deter defalcations. Further, during the five-month implementation period prior to the anticipated effective date of the rules, the Commission and its staff expect to continue to work with foreign regulators, the Joint Audit Committee representing all self-regulatory organizations, and other affected persons to apply the new foreign futures

and options rules so as to avoid the imposition of conflicting regulatory requirements on firms doing an international business.

3. Question. The Commission in its proposed rules provided for the registration of firms who sell foreign futures and options to U.S. customers. The Commission also proposed exceptions or alternatives to registration. Will the Commission have a "commercial exemption" in its final rules which will exempt those firms who only solicit U.S. customers who are "commercials" (persons who use foreign futures and options in connection with their business)?

Answer. After reviewing the comments received about this proposal and giving further consideration, the Commission, on the recommendation of its staff, decided to abandon the commercial exclusion in the final rules.

4. Question. Another exemption provided for in the proposed rules was the "country exemption" whereby if the Commission determined that a country had a regulatory structure in place equal to our own they could grant an exemption to individuals and firms from that country. In the final rules will the Commission provide for this "country exemption"?

Answer. The final rules contain a provision which would permit persons located outside the United States who are subject to a comparable regulatory scheme in the jurisdiction in which they are situated to seek an exemption from the application of certain of the Commission's rules.

5. Question. If so, would you clarify what standards you would use to make a determination whether or not a foreign country's regulation standards are comparable to ours?

Answer. The Commission staff has prepared an appendix to the proposed final foreign futures and options rules which contains an interpretive statement generally setting forth the elements the Commission will evaluate in determining whether a particular regulatory program may be found to be comparable to the Commission's program. The minimum elements of a comparable regulatory program would include requirements concerning: (1) qualification to do business, including fitness; (2) minimum financial requirements; (3) protection of customer funds; (4) recordkeeping and reporting; (5) sales practice standards; (6) compliance; and (7) information sharing. In addition, the foreign person who is the subject of the exemption must consensually submit to U.S. jurisdiction by designating an agent for service of process in the U.S. and must make its relevant books and records available for inspection in the U.S. (See Appendix A - Part 30, attached).

[¶ 2707]

Appendix A—Part 30—Interpretative Statement With Respect to the Commission's Exemptive Authority Under Section 30.10 of Its Rules

Part 30 of the Commission's regulations establishes the regulatory structure governing the offer and sale in the United States of futures and options contracts made or to be made on or subject to the rules of a foreign board of trade. Section 30.10 of these regulations provides that, upon petition, the Commission may exempt any person from any requirement of this part. Specifically, section 30.10 states:

Any person adversely affected by any requirement of this part may file a petition with the

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Secretary of the Commission, which petition must set forth with particularity the reasons why that person believes that he should be exempt from such requirement. The Commission may, in its discretion, grant such an exemption if that person demonstrates to the Commission's satisfaction that the exemption is not otherwise contrary to the public interest or to the purposes of the provision from which exemption is sought. The petition will be granted or denied on the basis of the papers filed. The petition may be granted subject to such terms and conditions as the Commission may find appropriate.

As the provisions of this section make clear, any person subject to regulation under part 30 may petition the Commission for an exemption. In adopting these regulations, however, the Commission noted in particular that persons located outside the United States that solicit or accept orders directly from United States customers for foreign futures or options transactions and that are subject to a comparable regulatory scheme in the country in which they are located may apply under section 30.10 for exemption from some or all of the requirements that would otherwise be applicable to such persons. This interpretative statement sets forth the elements that the Commission intends to evaluate in determining whether a particular regulatory program may be found to be comparable to the Commission's program.

The Commission wishes to emphasize, however, that this interpretative statement is not all inclusive, and that information with respect to other aspects of a particular regulatory program may be submitted by a petitioner or requested by the Commission. In this connection, the Commission would have broad discretion to determine that the policies of any program element generally are met, notwithstanding the fact that the offshore program does not contain an element identical to that of the Commission's regulatory program and conversely may assess how particular elements are in fact applied by offshore authorities. Thus, for example, in order to find that a particular program is comparable, the regulations thereunder would have to be applicable to all United States customers, notwithstanding any exemptions that might otherwise be available to particular classes of customer located offshore. A petitioner, therefore, must set forth with particularity the factual basis for a finding of comparability and the reasons why such policies and purposes are met, notwithstanding differences of degree and kind in its regulatory program.

No exemptions of a general nature will be granted unless the persons to which the exemption is to be applied consent to submit to jurisdiction in the United States by designating an agent for service or process pursuant to the provisions of rule 30.5 with respect to any activities of such persons otherwise subject to regulation under this part and to notify the National Futures Association of the commencement or termination of business in the United States. In this connection, to be exempted, such person must further agree to respond to a request to confirm that it continues to do business in the United States.

Persons located outside the United States may seek an exemption on their own behalf or an exemption may be sought on a general basis through the governmental agency responsible for the implementation and enforcement of the regulatory program in question, or the self-regulatory organizations of which such persons are members. The appropriate petitioner is a matter of judgment and may be determined by the parties seeking the exemption. The Commission, however, notes that it will be able to address petitions more efficiently if they are filed by the governmental agency or self-regulatory organization responsible for the regulatory program.

In this connection, as will be discussed in more detail below, any exemption of a general nature based on comparability will be conditioned upon appropriate information sharing arrangements between the Commission and the relevant governmental agency and/or self-regulatory organization. Representations from the appropriate governmental agency with respect to the applicability of any blocking statutes that may prevent the sharing of information requested under private arrangements would also be considered. Finally, in considering an exemption request, the Commission will take into account the extent to which United States persons or contracts regulated by the Commission are permitted to engage in futures-related activities or be offered in the country from which an exemption is sought.

In the Commission's review, the minimum elements of a comparable regulatory program would include: (1) Registration, authorization or other form of licensing, fitness review or qualification of persons through which customer orders are solicited and accepted; (2) minimum financial requirements for those persons that accept customer funds; (3) protection of customer funds from misapplication; (4) recordkeeping and reporting requirements; (5) minimum sales practice standards, including disclosure of the risks of futures and options transactions and, in particular, the risk of transactions undertaken outside the jurisdiction of domestic law; and (6) compliance.

Qualification. Under domestic law, registration identifies to the Commission, the public and other governmental agencies the individuals and enti-

ties that are properly authorized to solicit and accept customer orders and are in good standing. Equally important, the procedure provides the Commission, through the National Futures Association, the opportunity to determine whether applicants are unfit to deal with the public. In this connection, the standards for determining whether a person through its principals is fit for registration with the Commission are set forth in section 8a(2)-8a(4) of the Act. Timely access to information as to a firm's good standing and the application by relevant authorities of membership and licensing criteria, as well as the criteria themselves, will be considered by the Commission in assessing comparability.

Minimum Financial Requirements. Minimum financial requirements for persons that handle customer funds serve at least three critical functions. First, they provide a cushion together with margin such that in the event of a default of a customer, the losses of that customer need not adversely affect the funds held on behalf of other customers. Second, they help ensure that the person has sufficient funds to operate its business and, therefore, is less likely to be tempted to misapply customer funds for its own purposes. Third, they ensure that the person holding customer funds has some financial stake in its business and, therefore, is serious in its intent. In assessing comparability, capital rules or their equivalent will be considered together with any provisions made for insuring customer losses, the scope of clearing guarantees and segregation or customer trust calculation and accounting requirements which, to the extent they cover undermargined accounts, can provide significant protection of one customer from another customer's losses.

Customer Funds. The Act requires the strict segregation of customer funds from those of the person holding such funds. One of the primary purposes of this requirement is to prevent the misapplication of those funds for purposes other than those intended by the customer, which may affect not only the customer but the market as a whole. The purpose of segregation is also to identify customer deposits as assets of the customer, rather than the firm, in order that in bankruptcy such funds are payable only to satisfy the carrying firm's obligations to such customers and not other obligations of the firm. In assessing comparability of protection of customer funds, the Commission will consider protections accorded customer funds in a bankruptcy under applicable law, as well as protection from fraud.

Recordkeeping and Reporting. Recordkeeping requirements have long been recognized as the linchpin of the Commission's regulatory scheme. Reporting and recordkeeping requirements assist in determining that a registrant is acting in accordance with the provisions of the Act and the rules, regulations and orders of the Commission thereunder. Similarly, reporting requirements ensure that customers are timely advised of the transactions that have been executed on their behalf, thus ensuring that they are aware of their positions in the markets and may object to any transactions that they believe are in error. The Commission will consider the types of records maintained, the ability through those records to trace funds and transactions, and the period of retention and accessibility of records under the information sharing arrangements discussed below in considering comparability.

Sales Practice Standards. In 1982, Congress reaffirmed the importance of minimum sales practice standards to protect customers from fraud or misrepresentation by requiring any futures association registered by the Commission to adopt and enforce rules governing the sales practices of its members. The Commission has consistently provided that written disclosure of the risks of futures and options trading is essential to ensure that potential customers are aware of these risks and are not otherwise misled and that other appropriate disclosure is made. The Commission will review the type and manner of disclosure given and the mechanisms for assuring the disclosure requirements are met and, in particular, the treatment of discretionary accounts for which, for example, Commission rule 166.2 requires particularized documentation of intent to confer discretion in the case of foreign futures and options transactions.

Compliance. Finally, in assessing comparability of a program, the Commission will examine the procedures employed by the governmental authority or the appropriate self-regulatory organization to audit for compliance with, and to take action as appropriate against those persons that violate, the requirements of that program.

Information Sharing. As noted above, any exemption of a general nature would also require an information sharing arrangement between the Commission and the appropriate governmental or self-regulatory organization to ensure Commission access to information on an as needed basis as may be necessary to fulfill its regulatory responsibilities. The information subject to these arrangements generally would be of a type necessary in the first instance to monitor domestic markets and to protect domestic customers trading on foreign markets.

Firm-specific information that is potentially relevant to protection of domestic customers engaged in foreign transactions could include the

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following: (1) Registration qualification status; (2) names of principals; (3) current capital; (4) location of customer funds; (5) address of main office and branches; (6) exchange and self-regulatory organization memberships; (7) the existence of any derogatory information such as that required to be disclosed on the Commission's Form 7-R; (8) notice of limitations imposed on activities; (9) notice of undersegregation or undercapitalization; (10) notice of misuse of customer funds; and (11) notice of sanctions or of expulsion from exchange or self-regulatory organization membership. The Commission believes that much of the above information would be public in the ordinary course in most jurisdictions. From time to time, the Commission also may need immediate access to financial information concerning risks posed to domestic firms by the carrying of foreign positions.

In addition to information that relates to the financial stability and creditworthiness of the firm, the Commission should have access to transaction-specific information that confirms the execution of orders and prices and facilitates tracing of customer funds. Such data could include records reflecting: (1) That an order has been received by a firm on behalf of one or more United States customers; (2) that an order has been executed on an exchange on behalf of one or more United States customers; (3) that funds to margin, guarantee or secure United States customer transactions have been received by a firm and deposited in an appropriate depository; and (4) the price at which a transaction was executed and general access to pricing information.

Again, such information is likely to be maintained in the ordinary course of business. Tracing of customer funds would be most essential in cases of insolvency where repatriation of funds is at issue.

The Commission may also seek relevant position data information, including the identity of the position holder and related positions, in connection with surveillance of a potential "market disruption." This is particularly true in the case of integrated markets.

The Commission wishes to emphasize that the information sharing arrangements discussed herein are not necessarily a substitute for, nor would they preclude, a more formal agreement or arrangement with respect to the sharing of information.

[Aug. 5, 1987, 52 F.R. 28980 (¶ 23,740), effective January 4, 1988; Dec. 28, 1987, 52 F.R. 48811 (¶ 24,017), effective date of Jan. 4, 1988 postponed to Feb. 1, 1988.]

[The next page is 2801.]

6. Question. How will the Commission grant this exemption? In other words, will the staff or the Commissioners make the final determination?

Answer. The Commissioners consider and grant or deny exemption requests.

7. Question. Would a request for a foreign exemption be published for comment in the Federal Register?

Answer. It has not been the Commission's practice to publish requests for exemption in the Federal Register; however, the Commission anticipates that the implementation of the foreign futures and options regulations will be a highly visible program and interested persons will be able to obtain copies of the applications for exemption from the Commission upon request. Moreover, the Commission always will entertain general letters of inquiry with respect to a particular subject of concern.

8. Question. Recently you were quoted in the press as saying that you favored a global regulator for futures. Was that a fair quote?

Answer. No. There is, however, a need for increasingly higher levels of cooperation and maintaining open channels of communication with futures regulators in other countries in order to regulate effectively transnational futures transactions, and to avoid the imposition of duplicative regulatory requirements which would have only a detrimental effect on the harmonious and fair development of the international financial markets generally.

OFF EXCHANGE INSTRUMENTS

1. Question. Congress has mandated that all futures contracts must be traded on a Commission designated exchange. Yet there has been a rapid growth of new off-exchange instruments that look an awful lot like futures contracts. Does the Commission have any kind of an on-going program to review these off-exchange instruments to enforce the exchange trading requirement?

Answer. The Commission has established an internal staff task force to examine the range of complex policy issues raised by several new instruments that appear to have characteristics that resemble, in some degree, futures and options. The task force has already provided the Commission with a preliminary draft outline of the questions it proposes to examine, and on June 9, 1987, the Commission held a public meeting to discuss several of these questions and to give the staff direction on how to proceed with various aspects of the study. We will continue our examination of these transactions and, if appropriate, will undertake regulatory initiatives, enforcement actions, or make legislative recommendations to Congress. The Commission will keep the Committee apprised as the work of our task force progresses.

2. Question. Apparently there has been rapid growth of these off-exchange instruments which raises concerns of many regarding fraud in the marketing of such instruments. Have any of the state regulatory agencies or law enforcement bodies expressed any concerns over these off-exchange instruments and how they are retailed in their states?

Answer. The Commission has on occasion been contacted by state regulatory and other law enforcement agencies regarding the marketing to the public of clearly unlawful offexchange futures and option products, often accompanied by fraudulent sales practices. In this regard, the Commission's Division of Enforcement has in the last three years filed over 25 injunctive proceedings, several of which were brought jointly with the states, including Arizona, Texas, Missouri, Florida, New Jersey and California. The Division's State-Federal Liaison Unit also maintains active communication with state law enforcement authorities and conducts seminars for these authorities on how to develop a case against illegal, off-exchange operators. In addition, the Commodities Committee of the North American Securities Administrator's Association (NASAA) recently requested that the Commission consider withdrawing Office of General Counsel interpretive letter No. 85-2, concerning a particular bank-financed precious metals program. NASAA expressed concern about possible fraudulent practices in the marketing of such a program, which the interpretive letter determined involved neither a futures nor a leverage contract and therefore was not within the Commission's regulatory jurisdiction. NASAA's stated concerns and the policy considerations implicated by bank-financed precious metals programs are under review by the Commission's task force.

3. Question. What do you think are the factors that are encouraging this growth in this area? (Off-exchange)

Answer. In the commercial context, off-exchange commodity and commodity-related instruments are said to offer more highly customized terms, operational efficiencies, and potentially lower transactions costs and

perhaps greater profit potential than exchange-traded contracts. These may be among the factors that have encouraged the development of such new instruments.

4. Question. Do you see any possibility of some of these hybrid instruments being subject to both securities and commodities regulation?

Answer. To the extent that some of these hybrid instruments have characteristics of futures, options and securities, there may be regulatory interest on the part of the Commodity Futures Trading Commission as well as on the part of the Securities and Exchange Commission. The CFTC's jurisdiction over these instruments and how that jurisdiction, if any, should be exercised, is being carefully considered by the Commission's off-exchange task force.

5. Question. When a particular instrument is reviewed, how is a determination made or what criteria are used to decide whether or not to regulate such instrument? In other words, how do you determine if an instrument is a futures contract or an off-exchange instrument having characteristics of a futures contract or option?

Answer. The Commodity Exchange Act governs transactions involving contracts for future delivery of commodities but does not define these terms. Any contract for future delivery may be a futures contract. As an example, the Congress recognized this when it allowed certain transactions such as cash forward contracts, which otherwise would be futures contracts, to be traded off of a designated contract market. In determining whether or not an instrument is a futures contract, the Commission traditionally looks to a number of essential characteristics that have been cited in both Commission and judicial decisions. Elements that have been found to be indicia of futures contracts have included the following: (a) an agreement between two parties

for the purchase or sale of a commodity for delivery (or cash settlement) in the future at a price that is agreed upon when the contract is initiated; (b) both parties to the contract are obligated to fulfill the contract at the specified price by making or taking delivery (including cash settlement) or by offset; and (c) the purpose of the contract is to assume or shift the risk of price movements without transferring ownership of the underlying commodity. Other recognized characteristics of futures contracts include: standardized commodity units; margin requirements related to price movements of the underlying commodity; and no right or interest by the customer in a particular lot or other commodity unit.

Of course, not all futures contracts necessarily have all of these elements, nor is this list of elements determinative. In reviewing a particular instrument, therefore, the Commission examines the transaction as a whole. In instances where the Commission determines that the instrument is clearly an off-exchange futures contract, our Division of Enforcement initiates action to halt its promotion or sale. In the case of certain recently-developed so-called hybrid instruments, the Commission's staff task force examines these instruments with a view toward what regulatory measures should be taken.

6. Question. Do you or any of your fellow Commissioners feel that these instruments are forced off-exchange because of a too stringent regulatory burden, such as speculative position limits or the hedging definition?

Answer. The Commission's general view is that new forms of off-exchange instruments for commercial use are being developed not as a measure to escape "a too stringent regulatory burden," but as a means of satisfying specific commercial needs for customized transactions. Heightened interest

in these instruments may be related to the recent growth and internationalization of the financial markets and the economic risks attendant to this growth. While the Commission does not believe that these instruments are being developed off-exchange as a result of our regulatory program, we are actively reevaluating our hedging definition and speculative position limits to assure that exchange contracts can continue to trade in an environment that best serves the economic purposes of futures trading.

7. Question. Do you see any circumstances that exist or might arise in the future when the Commission believes it could waive the exchange-traded requirement?

Answer. The Commission does not have statutory authority to "waive" the Section 4(a) requirement that contracts for future delivery be conducted on or subject to the rules of a designated contract market. Should the Commission, as a result of the work of its task force, determine that waiving the requirements of Section 4(a) is a feasible and appropriate means of allowing future development of risk-management instruments, the Commission could recommend such a course of action to the Congress. The situation with respect to options is somewhat different, however, in that there exists no specific statutory requirement that options be traded only on an exchange. Nevertheless, the Commission will proceed carefully in determining the appropriate regulatory response in this area.

8. Question. Do you feel the Commission should be involved in the regulation of these off-exchange instruments and to what extent?

Answer. Congress has historically and continually stated that instruments designed to discover prices of commodities and to shift or assume the risk

of commodity price movements should be subject to regulation under the statutory scheme of the Commodity Exchange Act. Consistent with this policy, the Commission has directed its task force to examine the complex issues raised in order to assist the Commission in determining an appropriate regulatory response from the wide range of possibilities. These possible regulatory responses range from prohibition to some form of permissive action.

9. Question. One final question, with respect to the leverage survey mentioned in your written statement: Would the Commission be in a position of coming forward with its recommendation prior to the November, 1988 deadline? What kind of changes in the current rules do you foresee?

Answer. The Commission will not receive the National Futures Association's tabulation and report analyzing the leverage survey results until this coming November. It is premature to speculate as to what kinds of changes in the current rules might prove necessary and as to whether the Commission will be able to submit its report to Congress before the November 1988 statutory deadline. Of course, we will, if possible, submit our report before that deadline.

PROGRAM TRADING QUESTIONS

1. Question. You have presented this Committee with a review of stock index futures trading on January 23, 1987, relating to the activities in the stock and futures markets on that day. The report's basic conclusion is that the price drop of 44 points in the Dow Jones Average on that day appears to have been a correction to a rapidly rising stock market earlier that day and during the prior three weeks. In all the Dow had a swing of 115 points, or more than 6 percent, in a little over 70 minutes on January 23 and that appears at least to me to be a fairly significant move in a little over an hour. Even through a correction was warranted and appears to be the cause of the drop do you think "program trading" caused an increase in the size of the correction once it started?

Answer. We have concluded that the data do not tend to support a hypothesis that program trading caused an increase in the market correction on January 23. First, let me explain that Commission data show only the detailed futures trading activity. The staff did not review detailed securities data from the SEC or NYSE and thus has not calculated exact amounts of program trading done that day. The Commission did, however, consider the largest buyers and sellers of futures contracts and identified those normally associated with arbitrage programs or portfolio insurance. The potential quantities of securities traded based on futures market activities were small relative to the total volume of securites traded that day. Furthermore, most of this trading was done early in the morning or later in the day, after prices had reversed their course. We did estimate that some long-securities/short-futures positions were being unwound (by selling securities and buying futures) after the initial break in prices but before

the lowest prices were hit. Although this type of trading could tend to weaken further securities prices, the quantities involved appear to be no more than a small percentage of total securities volume that day.

2. Question. Looking at the opposite possibility on January 23, is it possible that rather than causing an increase in the size of the correction on that day that these stock-index futures might very well have had a stabilizing effect on the stock market by relieving some of the selling pressure?

Answer. Based on detailed futures data and many interviews with large futures traders, we found no evidence that large futures traders had much net impact on the securities market -- one way or the other -- that day.

3. Question. Your study of trading activity on that day indicates that at that time the stock volume reached a record high on January 23. Is there any way to determine or estimate what percent of stock volume would be attributed to futures trading using some system of program trading?

Answer. In the report, the staff specifically examined the potential for program trading among the 43 traders with significant net futures position changes -- 200 or more contracts. We found that, even if all of certain traders' futures activity were related to securities activity, the total amount of program trading would have been less than five percent of securities market volume that day.

4. Question. Has anything come out of the various studies, including your January 23 review of trading, conducted by your agency or the SEC or any other agency, that raised your concerns about program trading or the ultimate effects it might have on our equity markets?

Answer. Both the SEC and the CFTC have conducted studies of trading in stock index instruments on days when various indices have displayed unusually high volatility. Neither the SEC's nor our own analyses have found that program trading was a significant cause of such volatility.

In another area, both agencies have worked closely with the exchanges under our respective jurisdictions to address issues related to volatile markets at the quarterly expirations of certain stock index contracts (the so-called "third Friday" phenomenon). These efforts have resulted in changes in the settlement times of certain stock index contracts and enhanced procedures for information dissemination on the New York Stock Exchange.

5. Question. Do you see a continued increase in the volume of stock index futures and if so, do you see any problems arising in the ability to handle this increased volume if it does continue?

Answer. Total volume of stock index futures trading for the first six months of this year is up 4.6 percent from the previous year, while the volume in all futures markets for the first six months of this year is up 17.3 percent from the previous year. This relatively modest recent growth in stock-index futures volume is not unusual, and the Commission is fully able to handle this and higher levels of activity.

6. Question. Do you share any of the concerns expressed by John Phelan regarding his "Financial Meltdown" theory whereby the use of program trading in stock index futures will someday result in a cascading downturn in the stock market? (Portfolio Insurance)

Answer. The primary concern here appears to be that, unlike arbitrage activities that by their nature tend to reduce the condition that triggered them, portfolio insurance or dynamic hedging could cause a cascading effect as falling prices trigger selling, which drives prices down and begets more selling. The existence of futures markets, however, normally generates an array of traders willing to accept market risk when prices are perceived to have fallen below their fundamental values. Moreover, the existence of active arbitrageurs tends to spread the impact across related markets, particularly the most liquid, and thus dilute the impact on any one market. Conversely, in the absence of the ability to undertake portfolio insurance, the owners of securities portfolios instead may choose to sell the stocks directly in the stock market and potentially cause a greater price impact, at least in the short run.

7. Question. Do you see an increase in different types of users, such as more banks or financial institutions, that are not presently using these stock index futures?

Answer. As of June 30, over 60 large commercial traders (defined as holding 300 or more contracts in any one future) held 65 to 70 thousand — just over 60 percent -- of the nearly 110 thousand open contracts on the Chicago Mercantile Exchange's S&P 500 futures contract (the largest of the stock index futures). On June 30 of last year, over 40 large commercial traders held about 46 thousand — about 55 percent — of the 83 thousand

contracts then open. These data show that, over the past year, large commercial traders have increased both in number and in the proportion which they hold of the total number of open contracts on the largest stock index future.

8. Question. Do you feel comfortable with the regulations presently in place governing program trading and the systems in place governing the expiration days and, if not, what changes would you recommend?

Answer. Existing commodity exchange regulations regarding the trading and settlement of stock index futures contracts and options thereon, along with current NYSE stock trading systems, appear adequate to deal with program trading in general and stock index expirations in particular. However, the Commission and the exchanges continue to deploy significant resources to the day-to-day surveillance of these markets; and such efforts may identify potential improvements that could be made to exchange regulations.

OTHER QUESTIONS

1. Question. Your written statement refers to the implementation of the Exchange audit trail system and that beginning July 1, the exchanges systems, with the exception of the Coffee, Sugar and Cocoa Exchange, all had to be in place. Have all the exchanges implemented these audit trail systems? Have the results, if known, been satisfactory? Have you received or heard any comments regarding the benefits or problems in utilizing these audit trail systems from the Exchanges.

Answer. As of July 1, all exchanges had implemented systems they designed to meet the improved audit trail requirement, with the exception of the Coffee, Sugar & Cocoa Exchange. That exchange has implemented its new system in some but not all of its contracts and is working toward full implementation. The Commission has begun conducting in-depth oversight reviews of these systems to determine their compliance with the Commission's audit trail standard, with a goal of completing reviews of each exchange by the end of calendar year 1988. These reviews will describe each exchange system, identify strengths and weaknesses, and make recommendations for improvements.

Following these initial reviews, oversight of whether the exchanges continue to meet the Commission's standard will be an integral part of the Commission's regular oversight. The Commission views compliance with the improved audit trail requirements as an evolutionary process; as technology and trading systems and methods change, and the futures industry gains experience with the efficacy of their respective audit trail systems, these systems should evolve as well.

It is too early to document many benefits or problems flowing from the improved audit trail requirements. However, the Commission is aware of instances, which illustrate that the exchanges are taking these requirements seriously, such as at one exchange where a long-time member was fined $5,000 for failing to comply with new audit trail requirements. In addition, some exchange compliance staff have stated that the improved timing data, along with computer-assisted surveillance systems, have cut exponentially the time required initially to isolate trading patterns which may indicate abuses and to assemble cases for presentation to exchange disciplinary committees.

2. Question. In your written statement you refer to published rules establishing guidelines for those transactions in actual commodities and in futures in which Commission members and employees now may engage. Would you elaborate on what is presently allowed in commodities (futures and cash), by members and employees of the Commission?

Answer. Section 9(d) of the Commodity Exchange Act generally prohibits Commission members and employees from participating in commodity futures, options, or leverage contract transactions. Congress amended Section 9(d) in 1986 to authorize the Commission to exempt particular transactions or types of transactions from this general prohibition where the Commission determines that an exemption would not be contrary to the public interest or otherwise inconsistent with the purposes of Section 9(d). The 1986 amendments to Section 9(d) also permit Commission members and employees to engage in investment transactions in actual commodities unless (1) nonpublic information is used in the transaction; (2) the transaction is prohibited

by Commission rule or regulation; or (3) the transaction is effected by means of a Commission-regulated instrument.

The Commission recently revised its Code of Conduct to create two narrowly-drawn exemptions to the general prohibitions in Section 9(d) against futures and option transactions. These exemptions were modeled on examples provided by Congress in committee reports accompanying the 1986 amendments. Specifically, the exemptions cover (1) transactions engaged in by an investment company (e.g., a mutual fund) or similar pooled investment entity in which the Commission member or employee has less than a 1% ownership interest and no other relationship; and (2) transactions in connection with a ranching, farming, oil or other natural resources operation in which the Commission member or employee has a financial interest, but has no knowledge of or involvement in particular trading decisions and has previously reported to the General Counsel that such types of transactions may take place and certain other details. In adopting these exemptions, the Commission was guided in part by exemptions that existed in prior versions of the Act and determined that both types of transactions involve minimal conflict of interest concerns.

In the same rulemaking, the Commission prohibited its members and employees from engaging in investment transactions in actual commodities where the transaction is effected by means of an instrument functionally equivalent to an instrument regulated by the Commission (e.g., options on a stock index traded on a a national securities exchange where the same index underlies a Commission-regulated futures contract or an option on such a futures contract).

3. Question. The Chicago Board of Trade submitted proposed rules to the Commission in both the hedging and the aggregation areas. Approximately one month after the Board's rule proposals were submitted to the Commission, the proposals were remitted as not accepted for filing. Without commenting on the adequacy of the proposal wouldn't it be a more appropriate approach under section 5 of the Commodity Exchange Act to begin formal consideration of the rule change proposal and inform the submitter of the additional information which would be necessary to have the change approved by the Commission?

Answer. Unlike the statutory procedures for Commission review of applications for designation of contract markets which provide for a stay of the statutory review period for applications, which are materially incomplete, the Commission's 180-day statutory review period for proposed exchange rules does not include such a provision. Accordingly, where exchange submissions do not meet the form or content requirements for review by the Commission, they may be remitted and not accepted for filing. Alternatively, the Commission may request additional information while the review period continues to run or an Exchange may voluntarily agree to stay the running of the review period.

The primary reason for remitting a deficient rule submission, particularly one that raises complex issues or fails to address major concerns, is to ensure that the Commission has adequate time to give due and reasoned consideration to a properly completed proposed rule submission. The remittal of an incomplete or otherwise deficient rule submission is accompanied by an explicit statement of the problems which have been found, and this analysis provides a basis for the exchange's response.

The Commission has had significant experience in administering its review of proposed exchange rules under the procedures of Section 5(a) of the Commodity Exchange Act. The determination of which procedure is most appropriate in terms of a particular submission is dependent upon the nature of the inadequacy of the submission. Where the deficiency identified is substantial, raises complex or highly technical issues, including its conformance with the statute, or may require further action by an exchange board, the appropriate course of action is to remit the submission. On the other hand, deficiencies which are easily and readily correctable are often best handled by a brief request for additional information to be provided within a short time frame.

In this regard, it should be noted that a submission's remittal does not preclude an exchange from subsequently submitting a proposed rule for Commission consideration similar to the one remitted. Such resubmissions, historically, have been cured of the noted deficiencies and adequately justified, and their review has proceeded expeditiously.

4. Question. The Commission is currently considering revisions of speculative position limits in the agricultural markets. When do you anticipate issuing final rules amending the speculative position limits?

Answer. The Commission is currently reviewing over 79 comments from the public received in response to its Federal Register notice proposing amendments to Federal speculative position limits. The comment period on the Commission's proposed revisions to Federal speculative position limits ended on June 3, 1987, and many of these comments were received by the Commission through the middle of the month of June. A number of these comments are lengthy and technical in nature. After the Commission

concludes its review, it will evaluate modifications to the proposed rules based on these comments. The Commission presently plans to issue final rules this fall.

5. Question. Would you agree that raising the speculative position limits will add liquidity to the markets?

Answer. Speculative position limits are a safeguard designed to prevent positions which are extraordinary in size in relation to other speculative traders or the market. As such, speculative limits typically affect only a small number of the largest traders, and the impact of such limits must be assessed in those terms. In contrast, the level of speculative activity generally in agricultural futures is more directly related to many other factors, including the prospect for sharp price changes. At the present time, of course, the prices for many domestic agricultural commodities are at relatively low levels, and major changes are not anticipated in view of stock levels and government programs.

This is not to imply that increases in agricultural speculative limits are not appropriate in those cases where the markets have signficantly increased in size since the levels were last reviewed or that such increases may not have a beneficial effect in some circumstances. However, one must be careful not to attribute too much importance to the impact of limits upon agricultural market liquidity under current circumstances.

6. Question. Will the Commission simultaneously consider changes in the hedging definition and aggregation rule?

Answer. The Commission has been reviewing and modifying its speculative position requirements for several years. This process began in 1982 with the

requirement, and subsequent approval, of exchange speculative position limits for all commodities not subject to Federal limits. With the completion of that sizeable task, the Commission turned its attention to the remaining areas of reviewing Federal speculative position limits, the hedging definition, and aggregation. As noted in Question 4 above, the Commission's work on revising Federal speculative position limits is quite far along, having begun with an initial request for public comment in the summer of 1986.

With respect to the hedging definition, the Financial Products Advisory Committee recently issued a comprehensive report to the Commission on institutional uses of financial futures which the Committee developed over the course of the preceding fourteen months. Moreover, the Commission recently issued a Federal Register notice clarifying certain aspects of its hedging definition, 52 F.R. 27195 (July 20, 1987). In addition, a proposed rule amendment of the Chicago Mercantile Exchange adding an exemption from speculative position limits for certain risk management positions has been published for comment in the Federal Register. 52 F.R. 28744 (August 3, 1987).

While the initiatives concerning aggregation are more recent, this review also is well underway. Establishing an appropriate enforcement standard for positions that are not legally controlled by a trader is a major consideration of this review.

In sum, the Commission is considering all of these issues simultaneously and is proceeding expeditiously with all of them. However, the Commission will not delay implementation of any one proposal in order to implement all proposals simultaneously. Accordingly, because the Commission's work on

certain of these issues is more advanced than on others, as in the past it is anticipated that specific proposals or rules may be finalized and implemented before others.

7. Question. Will an increase in the speculative position limits and changes in the aggregation rule help individual investors participate in the futures market through managed accounts?

Answer. The Commissions' large trader data for markets subject to Federal speculative limits do not indicate that a very large number of accounts -- including managed accounts or pools -- are typically restricted by these limits. Nevertheless, persons representing managed accounts have asserted to the Commission that a combination of the current limit levels and the Commission's aggregation policy discourages trading of these agricultural futures by managed accounts or pools. The importance of this assertion is difficult to assess since there are many other factors which may impact the decisions of account managers or pool operators concerning which markets and in what amounts to participate, in particular, the level of price volatility which is currently low in the agricultural markets to which Federal speculative position limits apply. However, as I have already indicated, we are in the process of evaluating Federal limit levels and our aggregation policy to assure that neither contains unwarranted restrictions on market participation.

8. Question. Do you agree that overly restrictive speculative position limits and aggregation rules could have an adverse effect on the competitiveness of U.S. markets?

Answer. Because futures are integral to the logistical and merchandising methods of U.S. grain firms, as well as other agricultural producing and marketing enterprises, the efficiency and performance of these markets has a direct impact on the competitiveness of those firms in world markets. Accordingly, it is important that regulations concerning agricultural futures contracts strike the correct balance of trading activity while, at the same time, preventing abuses which are also detrimental to commercial operations.

9. Question. On November 13, 1986, the CFTC requested public comment on a petition filed January 31, 1986, by the Intermarket Clearing Corporation which would permit the cross-margining of positions in commodity futures, commodity options and securities options relating to the same underlying stock indices, foreign currencies and government securities. What progress has the CFTC made in considering these issues and do you have an anticipated time frame for final action on the petition?

Answer. The Commission published for comment a petition for rulemaking to permit cross-margining, submitted by the Intermarket Clearing Corporation ("ICC"). The Commission received a total of 35 comment letters, many of which were very extensive. Numerous comments raised major operational concerns regarding cross-margining. The Division of Trading and Markets currently is preparing a summary of comments which it expects to transmit to the Commission within the next several weeks. Based on its analysis to date, the Division of Trading and Markets believes that significant changes in Commission regulations would be necessary to implement cross-margining. The Division is continuing its analysis of the issues and has been in

contact with the Securities and Exchange Commission and the Securities Investor Protection Corporation regarding certain aspects of the proposal.

Commission staff is also currently reviewing proposed clearing rule amendments submitted by ICC which would permit cross-margining in the proprietary accounts of clearing members. This is a significantly more limited version of the cross-margining proposal described in the request for comments. The Commission's Division of Trading and Markets expects to recommend action on the proprietary cross-margining proposal within this calendar year.

The CHAIRMAN. I yield to the Senator from South Dakota.

Senator DASCHLE. Thank you, Mr. Chairman.

I think there is probably a great deal of interest in foreign exchange, the exchange of foreign securities in particular. For the last 4 weeks or so, we have been dealing with the multifaceted trade issue on the floor almost ad nauseam, and I think we may be dealing with it for another couple of weeks. It just goes on and on and on. And ironically, perhaps, in spite of the extended rhetoric and dilatory proceedings at times, little discussion has focused on an area that I think is especially a sensitive area in the issue of trade, and that is the futures industry and securities traded abroad.

There is an international implication to trade when it comes to securities that I do not think we are addressing very effectively in this country. More and more, I think our own boards of trade and the exchanges here are finding that the competition abroad, for a lot of different reasons, is becoming more keen and more successful, and ultimately, playing a greater role than it ever has in the past in providing the market where we are not providing one.

Just in the last couple of weeks we saw another example of that where Japanese bonds are now being sold in London. It has taken us over 2 years to consider whether Japanese bonds, government bonds, ought to be sold in Chicago. And while we continue to discuss the issue, while we continue to study it, while we continue to elaborate on policy here in the Congress, it is actually happening in London. And this kind of thing is going to happen over and over again.

There seems to be a long and very protracted analysis of whether or not Government bonds ought to be traded in this country and whether those contracts ought to be approved. It is becoming more frustrating, and I think it begs the question from those of us who are in a position to make a decision with regard to the expeditious consideration of contracts of this kind; how we can more aptly deal with applications of this kind in the future, and how we can circumvent the laborious and oftentimes fruitless examination of these contracts for the extended period that we are.

I would be interested if you, Ms. Phillips, could address that for a moment.

Ms. PHILLIPS. Let me speak perhaps generally and then go to the long-term Japanese Government bond question. First of all, I think that the contract market designation process generally has been one of the most important and central tools in our regulatory system. The basis of prevention of fraud and manipulation is whether or not the contract itself is well designed. So the contract market designation process has long been built into our regulatory system.

I will say that the Commission has made a sincere, and I think effective, effort in the past several years to speed up and streamline that process. The length of time during which it takes to approve new contracts has narrowed significantly, and——

Senator DASCHLE. Is 2 years the exception or the rule?

Ms. PHILLIPS. That would certainly be the exception, although I would say that—I am not sure what you are citing, because with respect to the——

Senator DASCHLE. The Chicago Board of Trade example with the Japanese bonds is the one that comes to mind.

Ms. PHILLIPS. That was submitted in April of this year, so it has not been on file with the Commission.

Senator DASCHLE. Well, it was formally submitted, but it has been pending for a period a lot longer than just April.

Ms. PHILLIPS. OK. I am reminded that it was necessary for the SEC to do some rulemaking because I guess the Japanese Government securities had to be designated as exempted securities for purposes of our approval; otherwise we would not have been able to approve it. But that has moved forward, and following that rulemaking by the SEC, the Chicago Board of Trade did submit the government bond contract. It was put out for comment, and the comment period has just closed. And we would hope to consider it later this year.

Senator DASCHLE. Well, I would hope we could expedite. I think it is one of those examples where if we are not able to respond more adroitly, and certainly in a more practical fashion, whether it is a lack of communication between the SEC and the CFTC or whether or not, as you say, we need more consistent rulemaking with regard to contracts of this kind, I think it is important that we look at it from time to time in this committee. I certainly will be one who will be watching with great interest as these applications and these contracts come about.

Let me ask you another question and then this will terminate my part of this hearing.

I think it was last year or the year before, many of us expressed a great deal of interest in the proliferation of nonexchange-traded instruments. And I know that with the last reauthorization came the requirement that a study be made of these nonexchange-traded instruments, and as I understand now, a study is underway.

I would be interested if you could enlighten us with regard to the progress of that study, when you expect it may be completed—what, if anything, you have found out at this point.

Ms. PHILLIPS. Yes. The Commission has set up an internal staff task force, which first of all was doing some information-gathering to determine what kind of instruments are out there and trying to estimate what kinds of things we might be seeing coming down the pike. That off-exchange task force was set up earlier this year. They reported to the Commission, in fact, in a public meeting in June of this year and presented for the Commission an outline of the areas they had been looking into. The Commission at that time provided some guidance as to the specific areas they would like to see the staff concentrating in.

Specifically, we are looking at hybrid kinds of instruments; we are looking at instruments that might be attempted to be traded under the Treasury Amendment. We are looking at what we loosely call the 85–2 question, that has to do with bank-financed metals programs.

So there are a number of areas that the Commission is looking into. It may be necessary to engage in some kinds of rulemakings, at which time there would be a public comment process.

Another area has to do with—how shall I word it—export financing programs that are done through banks. And to date, we have

had one application or one request for a no-action position, but that was only approved pending approval of the Fed, and that is now before the Federal Reserve Board.

So there are a lot of pieces of the study, and the Commission has directed the staff to move forward in several particular areas. And in my written testimony that I submitted for the record, I think I detailed all of these areas and exactly where we are, and we will be pleased to keep the committee informed as we progress with this study.

Senator DASCHLE. That would be very helpful.

Thank you, Mr. Chairman. Thank you, Ms. Phillips.

The CHAIRMAN. Dick, if you would just yield to me for 1 minute, please, I know it is your time. Just a little bit of déjà vu with my good friend Senator Lugar. I was thinking about when we were both junior members of this committee, and we were handed two assignments. The two of us were picked to rewrite FIFRA, which is the pesticide legislation, a matter of great excitement for over 16 months—varying degrees of excitement, I might say, as we sat through late Friday afternoon hearings. The other was the reauthorization of the CFTC.

It was probably an example of either our failure to grasp the big picture or our persistence that we remained on the committee after being assigned both those issues. [Laughter.]

The CFTC was a most complex area, and I am happy to have Dick here with me, because after going through all that work together, it helps us to understand it now and that is why I really urge the administration to expedite the naming of a new Chairman. And I am sure, Ms. Phillips, you join me in that request. You would probably like to see somebody named so that you could at least chat with him or her before you leave town this month. It is extremely important. It is too important an area of jurisdiction to ignore and whoever is here from the administration, send the same message back that I have sent before—get somebody up here so we can start the confirmation process.

If I could just ask one question, Dick.

Ms. Phillips, the latest triple witching hour is June 19. Do you feel the change in using the opening prices rather than the closing prices for settlement purposes contributed to a more orderly unwinding of these large arbitrage positions?

Ms. PHILLIPS. Of course, we only have the one date on which to judge an estimate, but that expiration did proceed very smoothly.

I will say that a lot of work went into it by the relevant exchanges and the Commission. I think we will have to watch it more carefully, but some change was made to the opening procedures at the New York Stock Exchange, and that was very helpful. So I think the move was helpful.

The CHAIRMAN. Would you have your staff keep in touch with us up here? I know you will be watching its progress—I would be interested in that process.

Ms. PHILLIPS. Yes, sir, a blow-by-blow description.

The CHAIRMAN. Thank you.

Ms. PHILLIPS. Thank you.

The CHAIRMAN. It is all yours, Senator Lugar. Thank you very much.

Senator LUGAR [presiding]. Thank you, Mr. Chairman.

I join the chairman in the hope that the administration will make that nomination of the Chairman promptly. We will encourage that to come about.

Ms. PHILLIPS. I hope so, but let me say that I have very able colleagues, and the Commission will move forward without me. So I am sure you will not even miss a heartbeat.

The CHAIRMAN. I do not want anybody to think that I was suggesting otherwise, but I suspect that all of you prefer to have a full five members there.

Senator LUGAR [presiding]. Let me ask that there be inserted in the record a statement by the distinguished Senator from Kentucky, Senator McConnell, which he would have made if present, and a statement in which Senator McConnell says: "We understand that the Commission has received several petitions to remedy this competitive problem of a lengthy new product approval period. We urge the Commission to act favorably on those petitions to ensure the continued competitiveness of the United States futures industry. In particular, we urge the Commission to reconsider its requirement that options on a futures contract must be delayed until trading volume in the underlying futures contract reaches specific levels because of the anticompetitive effect this requirement has regarding a similar securities option product which has no similar requirement."

[See page 5 for the prepared statement of Senator Mitch McConnell, a U.S. Senator from Kentucky.]

Senator LUGAR. Do you have any comment in response to Senator McConnell's statement?

Ms. PHILLIPS. Yes, sir, I will be pleased to comment on that.

When the options pilot program was converted to a permanent program, the rules were reviewed, and that one in particular was in fact strengthened. The Commission was concerned at that time about a potential exercising of options into illiquid futures positions.

We have, however, proposed a change to the options regulations that would allow exchanges to apply for exemptions; and they could apply for an exemption, for example, with respect to that particular rule.

Certainly, if exchanges would like to see that particular rule changed on a permanent basis, they could request or petition the Commission to make a rule change and it would be considered. But at least we are providing for an exception basis by which particular contracts could be considered, and we are doing that on our own initiative.

Senator LUGAR. I have two other questions that Senator McConnell has requested that I raise in the hearing. The first is, I take it that you agree, Madam Chairman, that the increase in alternatives to traditional futures products requires that the contract approval process be as expeditious as possible?

Ms. PHILLIPS. Certainly, it should be as expeditious as possible, and I believe that we have endeavored to streamline that process.

I would say that we do, of course, have to balance that against making sure that there are adequate safeguards in the trading systems, that the delivery system is appropriate, that it is not a ma-

nipulable contract. And of course, we are required to coordinate certain contracts with the SEC, and they have some say as to certain contracts.

So, bearing in mind that we would not want to precipitously approve contracts, I think that we have endeavored to streamline the process as much as we can, consistent with our responsibilities under the act to prevent manipulation.

Senator LUGAR. Don't you agree, Madam Chairman, that a futures exchange should not experience a competitive disadvantage to a securities exchange regarding the ability to trade new products solely because of disparate regulatory approval periods?

Ms. PHILLIPS. Theoretically, certainly that is the case. But if the act requires that we go through a designation process, of course we would do so.

I might say that in some instances, the SEC's approval process is as lengthy or lengthier than ours, and particularly where there are contracts that might be traded under dual jurisdictions, the staffs are working to coordinate the approval process. So I do not believe that that is a significant process, and the staffs are in fact working to try to alleviate any rough spots should they occur.

Senator LUGAR. Let me ask you, Madam Chairman, just for my own curiosity, at the time of the reauthorization and the discussion by the committee and the Commission of responsibilities that you have assumed given these expanding markets, and we have also discussed the size of the staff, the budget, the financing of the Commission from time to time, at this oversight hearing can you give us some type of benchmark idea of how you are coming. That is, is the size of the staff appropriate to the responsibilities that the Commission has? In regard to the financing of the budget, have the means employed been appropriate, and are they sufficient, or do you have comments that might be helpful for our consideration?

Ms. PHILLIPS. Certainly, as you know, in the past 5 years, volume has approximately doubled, and the size of the staff has not increased anywhere near that level. We have had a fairly small increase.

The Commission has really undertaken to accommodate the growth in the size of the industry in several ways. We have endeavored to mechanize, computerize as many of our operations as we could. We have also sought to delegate more of our responsibilities to self-regulatory organizations, most notably, the National Futures Association, and both the exchanges and NFA have increasingly been picking up certain kinds of responsibilities.

We have also asked them to mechanize some of their processes so that we can more efficiently integrate with their systems.

We have also internally been reviewing our own operations to try to determine whether or not everything we do need be done. We have tried to reexamine and reallocate staff internally so that we are making the most efficient use of our resources.

In spite of all of those kinds of things, we have found it necessary to request increases, and as you know, in the 1988 budget, the Office of Management and Budget has agreed that we need these certain level of increases.

There are some kinds of things we simply cannot delegate to the exchanges, particularly in the enforcement area. Most of our sur-

veillance activities, of course, cannot be fully delegated to the exchanges.

So there are a number of things that we must retain, and we have found it necessary to seek increases, and we are very hopeful as it wends its way through the process—we have not yet seen the appropriation bills for next year, but I think that our requests have been fairly listened to by the administration and by the committees on both sides of the Congress.

So I think that if we receive what we have requested, we will be in very good shape.

Senator LUGAR. I note that in your response to that question, you mentioned the procedures that really only the Commission can deal with, that cannot be delegated, and you mentioned specifically enforcement areas.

Obviously as this hearing, and each one on CFTC, demonstrates the subject matter with which you deal for most Americans is highly complex, even for those who are very sophisticated as investors, and forces highly complex. Are you able to recruit the persons that you need that have sufficient background and expertise in the areas in which you have jurisdiction—both attorneys and other technical personnel? Have they been available to you, or can you give us any insight as to how you employ persons who can handle these very complex affairs?

Ms. PHILLIPS. Let me say this is a continual challenge for us. Certainly, since there are areas that we cannot delegate, the major area where these folks are going to learn how to do it is through in-house training. So we have had to develop significant in-house training programs.

We have also tried in the enforcement area to get the States more involved in the off-exchange fraud areas, so that there are more people looking for these kinds of—particularly the boiler room activities.

While I must say that it is a continual challenge and certainly, once people have spent several years at the Commission, the temptation to go off is great. I think that the work is certainly challenging enough, and it is very good experience. I think we have got a very capable staff. But I do have to say that is an area that we have to continually work at. And it is not just the attorneys. It is the economists, the accountants, the investigators, and the computer people, because all of those are very competitive areas in the job force, and we compete along with everyone else.

Senator LUGAR. In the last two reauthorization debates and series of hearings, there has been a great emphasis upon cooperation with the State agencies, and we have had testimony by commissioners from the States or other people who are interested in State government. Some of them were highly critical at the time; others, much less so. But how would you characterize—you mention that you have had good relations, you have put the State enforcement people. At least it has not come to the attention of the committee, as far as I know, that there have been great disputes with the States in terms of either jurisdiction, lack of vigor or what-have-you.

Can you give us some insight as to the relationship and any problems that lie out there with regard to State cooperation?

Ms. PHILLIPS. I think that the times in which there was considerably more tension was in the period of the early 1980's. And of course, in 1982, we requested some changes to the act that would allow more cooperation.

We have done a number of things to try to aggressively work with the States. First of all, we have set up a unit within the Enforcement Division, a State-Federal Liaison Unit, specifically, to work with the States.

We have also reorganized the CFTC State Advisory Committee under the leadership of Commissioner Fowler West. It has been reorganized. It used to be literally a jurisdictional discussion forum, and it has now become a cooperation advisory committee. And we have worked through that committee, and directly with North American Securities Administrator's Association, NASAA, for example, to develop a Model State Commodity Code, which would dovetail the Commodity Exchange Act with the State codes. Our Enforcement Division has been conducting a number of seminars in cooperation with NASAA and with the participation of the State authorities. We have put Commissioner West on the road more than one time to go and testify at a number of State legislatures when they were considering the Model State Code.

So I think we have been very aggressively working in this area. I must say, and as you point out, these are very complicated cases, and we find that we have to, at this point, still do a lot of work in the development of the cases. But we are seeing some results of this educational effort, and I will cite the State of Florida in particular where boilerroom fraud was a hotbed. The State of Florida became very aggressive, passed their own boilerroom statute, and we have worked with them on that process. I think we have seen some real progress there.

I would say we have considerably more progress yet to make, particularly in the Southwest. So I think it is something we have got to keep working at, but we have initiated a number of programs to try to do so.

Commissioner West, would you add anything to that?

Mr. WEST. Madam Chairman, no, but I think the only thing I would say is that certainly the reconstitution of the Advisory Committee has been most helpful.

Ms. PHILLIPS. It has changed the tenor of that Committee entirely.

Mr. WEST. And the Model Code has been adopted by a number of States—I think now, seven or eight in one form or another, and we are seeing an increased interest in the States in the Model Code.

Senator LUGAR. I think that is a very important achievement of the Commission to have had that impact and the cohesion of the States in the adoption of those codes is bound to be good in terms of the general fabric of enforcement in our country.

During the last reauthorization debates, at the time there was still great fear on the part of some members of the committee that options would present problems, and the renewal of that idea was creating some consternation, and the Commission decided to develop a program, that was a limited one, of allowing exchanges to try on, one at a time or rather slow growth, as people got used to the idea after a hiatus of about 50 years, I guess.

We have not had much of a dispute as far as I can tell in recent weeks and months. How would you characterize what has occurred in that area? That was certainly a hot area of discussion and quite an extension, obviously, of the program of the Commission.

Ms. PHILLIPS. As you mentioned, we did not leap into it. We went into it very slowly with a pilot program, first with the nonagricultural options and then with the agricultural options, and we lifted various pieces of the pilot slowly.

Going at it very slowly not only allowed, certainly the regulatory system to be monitored carefully and to be developed slowly, but it also allowed the exchanges to introduce different trading vehicles that are quite different from futures trading. So when we started out with only one per exchange, while I think that the exchanges would have certainly preferred to have more, we started out with only one per exchange. I think that it gave them the opportunity to go a little more slowly, and for traders to get used to the system—and also for the futures Commission merchants, all of the entire trading community.

We have really not had difficult problems with options. There was one instance where a clearing firm did go under because certain of its customers were trading in options and did not meet margin calls. However, that could have happened actually outside of options for that matter. And significant regulatory steps were taken following that to shore up the systems, and customers eventually did not lose any money with respect to that particular instance.

So from our perspective, it has been a very successful program. We now see that options have been added to about one-third of the actively traded futures contracts. So we are now starting to see an environment where options are becoming a part of the entire risk management, hedging environment. So I think you will be seeing more of them and not less of them in the future.

Senator LUGAR. Do you have, perhaps as a part of your staff background, any figures on how many exchanges are now supervised by CFTC, how many employees those exchanges have, what the volume of dollar transactions is in a year, and some idea of the size of the industry in which you are now involved?

Ms. PHILLIPS. I would be happy to get those particular numbers to you for the record. I do know that in very general terms, that the compliance and operational staffs of the exchanges have been increased significantly in the past few years. They, of course, have had to deal with the operational matters associated with increased volume, new kinds of instruments, and of course, the increased reporting requirements of the audit trail.

Through our oversight process via the rule enforcement review mechanism, that is an area that we specifically look at the number of compliance staff that they do have, and in fact, have made recommendations to some exchanges on some occasions that they need to strengthen certain programs within their operations. So I would be glad to get the complete numbers for you. But my memory, just from reading all these rule enforcement reviews, I am aware that the exchanges have made significant improvements in their staffing, particularly in the operational and compliance areas.

Senator LUGAR. I appreciate that, and if you would supply that for the record, that would be helpful.

[The material was subsequently supplied and follows:]

1986 EXCHANGE COMPLIANCE BUDGET AND STAFF SIZE [1]

Exchange	Budget	Staff size
Chicago Board of Trade: [2]		
Audit	$1,240,000	30
Compliance	3,797,000	40
Chicago Mercantile Exchange:		
Audit	1,504,000	20
Compliance	4,421,000	31
Coffee, Sugar & Cocoa Exchange:		
Audit	439,200	4
Compliance	1,182,200	11
Commodity Exchange, Inc.: Audit and Compliance	1,527,135	29
Kansas City Board of Trade: Audit and Compliance	368,500	7
Minneapolis Grain Exchange: Audit and Compliance	167,350	3
New York Futures Exchange: Audit and compliance	869,000	17
New York Futures Exchange:		
Audit	[3] N.A.	2
Compliance	N.A.	9
New York Mercantile Exchange:		
Audit	303,245	6
Compliance	819,359	18

[1] The Amex Commodities Corp. and the Philadelphia Board of Trade are not listed separately because their respective securities parents, the American and Philadelphia Stock Exchanges, provide audit and compliance services, but do not distinguish them for budgetary purposes from those supplied for the stock side.

[2] The Chicago Board of Trade also provides audit and compliance services for the MidAmerica Commodity Exchange and Chicago Rice and Cotton Exchange.

[3] Although the New York Futures Exchange provided figures for staff size, the budget figures are combined with those of the parent New York Stock Exchange, and are not able to be segregated accurately.

Senator LUGAR. I would just make the observation, as the chairman and Senator Daschle made, that we have been discussing the trade bill and our whole role in international trade, and of course, a significant part of that which we will probably not discuss in this particular bill is the fact that our services through securities markets and through financial instruments become an extremely part of our foreign trade outlook.

It is ironic in a way. This may correct itself or be corrected, that whereas goods and services are being sold to us by other countries, we are in fact selling to other countries bonds, stocks, options, a good number of financial securities, that there is always balance in the arithmetic of foreign trade and that much of what we have had to sell has been in some of the areas that you cover, and the SEC, of course, and others in our country.

I would just add to the comments the chairman made, because it was my privilege to work with him in the very first year that I was in the Senate on the reauthorization of CFTC. That was the first reauthorization after the Commission had been founded, and it was an important time. And the 1982 reauthorization, with Senator Boren playing a leading role in that, was an important one as you have pointed out, in terms of large numbers of rules changes, significant strengthening as the dynamism of the whole securities industry and the part that you cover grew.

We have had a milder reauthorization subsequently, and I trust we will have one in due course in the near future. I think you

pointed out October 1988 for the moment. Is that the terminal date that we are looking toward where reauthorization is required again?

Ms. PHILLIPS. Yes, it is leverage for 1988, but reauthorization 1989.

Senator LUGAR. Well, I appreciate again your willingness to answer these additional questions, and in the absence of the distinguished chairman and my colleague, I will declare that the hearing is adjourned.

Ms. PHILLIPS. Thank you very much. We appreciate the opportunity to appear before you.

[Whereupon, at 12:10 p.m., the committee adjourned, subject to call of the Chair.]

[Material submitted for inclusion in the record follows:]

PATRICK J. LEAHY, VERMONT, CHAIRMAN
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United States Senate
COMMITTEE ON
AGRICULTURE, NUTRITION, AND FORESTRY
WASHINGTON, DC 20510-6000

July 17, 1987

Commissioner Charles C. Cox
Acting Chairman
Securities & Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear Commissioner Cox:

The Committee on Agriculture, Nutrition, and Forestry held oversight hearings of the Commodity Futures Trading Commission on July 15, 1987. The Committee on July 13, 1987 received information from the CFTC that during the months of August through December 1986 Ivan Boesky and entities affiliated with him actively traded in stock index futures and held substantial futures contract positions in the New York Future Exchange's N.Y.S.E. Composite Stock Index and the Chicago Mercantile Exchange's Standard and Poors 500 Stock Index. (Boesky's futures positions).

At the hearing, in response to my questioning, Chairman Susan Phillips of the CFTC stated that neither the Securities & Exchange Commission nor any members of its staff had contacted the CFTC concerning Boesky's futures positions or the SEC settlement with Mr. Boesky on insider trading charges until one hour before the public announcement of the settlement on November 14, 1986.

The Committee is anxious to know what consideration, if any, was given by the SEC or its staff to Boesky's futures positions or his trading activity in stock index futures contracts in recommending or accepting the terms of the settlement agreement on insider trading charges. The Committee also wants to know whether the SEC monitored Mr. Boesky's futures positions or futures trading activity between the period when settlement was reached with Mr. Boesky and when it was announced to the public.

The Committee's Chief Counsel raised these matters with Mr. Gary Lynch, Director of the Division of Enforcement, in a telephone conversation on July 14, 1987. Mr. Lynch informed our Counsel that he could not discuss these matters without authorization and direction from the Commission. Therefore, on behalf of the Committee, I am formally requesting answers to the following questions:

1. During the negotiations of the settlement agreement, was the SEC aware of Mr. Boesky's futures positions in the stock-index futures market or that he was actively trading in these markets?

2. During these settlement negotiations between the SEC and Mr. Boesky were there any discussions between the SEC and Mr. Boesky or his attorneys, Mr. Pitt or Mr. Levine, concerning Mr. Boesky's futures positions or his trading on stock index futures markets?

3. When was the special compliance agent, referenced in paragraph 2 of the settlement agreement between Mr. Boesky and the SEC, appointed by the SEC?

4. After the settlement between the SEC and Mr. Boesky was signed, were Mr. Boesky's futures positions at any time monitored by the SEC or by the special compliance agent appointed by the SEC pursuant to the settlement agreement?

5. How did or does the special compliance agent inform the SEC of Mr. Boesky's activities in the stock market which are permitted pursuant to paragraph 2 of the settlement agreement?

6. Did any of these reports on Mr. Boesky's stock market activities make reference to Mr. Boesky's futures positions or his trading on stock index futures markets?

7. Did Mr. Boesky maintain any positions in options on stock indexes during settlement negotiations or after the settlement between Mr. Boesky and the SEC was signed?

8. Did the special compliance agent's reports make reference to any trading by Mr. Boesky of options on stock indexes?

9. If indeed, Mr. Boesky had positions in options on stock indexes which were monitored by the special compliance agent why would he not have the same interest in monitoring Mr. Boesky's stock-index futures positions?

10. Was there ever any consideration given during the negotiations of the settlement agreement between Mr. Boesky and the SEC to advising the CFTC of such negotiations?

In response to the above questions, please include the futures positions (or options on futures) owned or controlled, directly or indirectly, on behalf of Mr. Boesky or any persons (including family members) or entities associated with him from August 1, 1986 through November 14, 1986.

The Committee believes that the case raises important policy issues and concerns regarding appropriate coordination between the SEC and CFTC in law enforcement cases. The information the Committee seeks will be helpful in analyzing those issues and concerns.

Your cooperation and prompt attention to this matter would be greatly appreciated.

Sincerely,

PATRICK LEAHY
Chairman

PJL/jp

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

August 31, 1987

The Honorable Patrick J. Leahy
Chairman
Committee on Agriculture, Nutrition and Forestry
United States Senate
SR-328A Russell Senate Office Building
Washington, D.C. 20510

Dear Chairman Leahy:

This is in response to your letter of July 17, 1987, concerning the Commission's resolution of SEC v. Ivan F. Boesky, 86 Civ. 8767 (RO) (S.D.N.Y.). You have asked a series of questions regarding the manner in which the settlement was reached and structured. As you are aware, I was not at the Commission at the time the Commission considered the Boesky settlement. Thus, I have relied on information provided to me by the Commission's staff in order to respond to your letter.

It may be helpful in responding to your questions to put the Boesky settlement in context. The Commission's discussions regarding a settlement with Mr. Boesky were parallel to discussions between counsel for Mr. Boesky and the Office of the United States Attorney for the Southern District of New York ("USAO"). The principal objectives of the Commission were to ensure that Mr. Boesky was enjoined from future violations of the federal securities laws; that he disgorged profits that he or companies under his control obtained while in possession of material nonpublic information received from Dennis Levine (and paid an appropriate penalty under ITSA); and, following a closely supervised transition period to prevent unnecessary losses to potentially innocent persons, that he was barred from the securities industry. The USAO sought a plea to an appropriate federal felony. Both the Commission and the USAO believed that obtaining Mr. Boesky's cooperation in the investigation of other potential violations of the federal laws was critical to the continuing investigation of insider trading and other law violations by both agencies.

These discussions culminated in the execution of letter agreements between Mr. Boesky and the Commission and Mr. Boesky and the USAO, respectively. These agreements, of which you have copies that include all material terms, gave both the Commission and the USAO all of the relief that each agency deemed appropriate. The agreements provided that the contemplated administrative, injunctive and criminal matters would be filed in the future once their precise terms had been worked out between the parties, but that Mr. Boesky's cooperation with the authorities would begin immediately, even before definitive court documents had been drafted. During this interim period, which ended on November 14, 1986, the USAO believed it most important to obtain Mr. Boesky's assistance in the collection of evidence as a cooperating witness by, among other methods, conducting monitored conversations with suspected violators of the federal criminal laws.

If this type of investigative effort were to be successful, it was essential that knowledge of Mr. Boesky's agreement and cooperation with the government be tightly held and kept on a need-to-know basis. On-site monitoring of Mr. Boesky's activities by government agents would have immediately alerted employees of Mr. Boesky's firm and the investment community of unusual activity at the firm. In addition, off-site (and thus necessitating after-the-fact) monitoring of trading activities would not have prevented trades from occurring and also would have required the cooperation of persons within the Boesky organization, other than Mr. Boesky, which would, in turn, have exposed Mr. Boesky's cooperation.

At the same time, it was also recognized that Mr. Boesky had to comply with both the federal securities laws and other laws. Both the Commission and the USAO took steps to ensure such compliance. Thus, the Commission's agreement with Mr. Boesky expressly limited his civil immunity to "conduct occurring prior to the date of this Agreement." Neither Mr. Boesky nor any person or entity affiliated with him was given any immunity for any violations of law occurring after the date of the agreement.

Thus, had Boesky violated either the federal securities or commodities laws during the period preceding the entry of the injunction on November 14, 1986, he would have been in breach of his agreement. In that case, any evidence he had given the government, including his own admissions of illegal conduct (in addition to that charged regarding insider trading on tips from Dennis Levine), could and would have been used against

him. These safeguards built into the respective settlement agreements provided a powerful incentive to comply with the law. Mr. Boesky also had the active and ongoing advice of counsel expert in federal regulations pertaining to his investment business who had negotiated, and understood the importance of, the terms of his agreements with the government. Thus, Mr. Boesky understood that he could not commit further violations without losing the benefits of his agreement. Moreover, Mr. Boesky's firms continued to be subject to the routine surveillance efforts of the stock, options and futures exchanges and the SEC and CFTC.

Although this system did not provide for on-site inspection of Mr. Boesky's daily financial activities, it was apparently successful. During this period, the stock market and its indices generally rose in price, thereby rendering the short futures positions unprofitable. There is no evidence of which we are aware that Mr. Boesky violated the law in his stock or futures activities from the date of his agreement with the government onward.

The Commission's effort to time the announcement of Mr. Boesky's injunction and administrative sanction so as to reduce to the extent possible adverse effects on the market in general was also successful. By the close of the market on November 14, the companies whose investments were managed by Mr. Boesky were sufficiently liquid that there was no need for margin, stock loan and other calls which could have forced mass liquidations of hundreds of millions of dollars worth of securities with the possibility of a snowball effect on the marketplace in general. Although the Dow Jones Industrial Index declined on November 18 and 19 with the publication of news that certain persons had received subpoenas issued by the Commission and that tape recordings had been made of persons' conversations with Mr. Boesky, the market reaction corrected itself. On November 14, the Commission notified officials of other relevant regulatory agencies and organizations who were in a position to monitor possible unusual developments and take corrective action if needed.

With this background in mind, let us turn to your specific questions. In answering these questions, references to trading or transactions by Boesky refer to trading in accounts managed by him and not in personal accounts.

Question 1: During the negotiations of the settlement agreement, was the SEC aware of Mr. Boesky's futures positions in the stock-index futures market or that he was actively trading in these markets?

Answer: The Commission's staff was generally aware that Mr. Boesky conducted futures transactions incident to his stock market investing. The Commission was not specifically aware of the size or nature of these positions.

Question 2: During these settlement negotiations between the SEC and Mr. Boesky were there any discussions between the SEC and Mr. Boesky or his attorneys, Mr. Pitt or Mr. Levine, concerning Mr. Boesky's futures position or his trading on stock index futures markets?

Answer: As noted above, it was contemplated that Mr. Boesky's organizations would continue to engage in trading securities during the period between the entry into settlement agreement and the filing of the civil injunctive action and administrative proceeding. It was imperative to the ongoing investigative effort that trading activity continue with the safeguards built into the settlement agreements. The Commission did not attempt to monitor directly the specific trading decisions made by the Boesky organization during this period, either in securities or commodities. As noted, both the Commission and the United States Attorney's Office stressed the need for Mr. Boesky to obey all federal laws and built into their agreements provisions designed to accomplish this result.

Question 3: When was the special compliance agent, referenced in paragraph 2 of the settlement agreement between Mr. Boesky and the SEC, appointed by the SEC?

Answer: Gerald F. Rath was appointed special compliance agent on November 14, 1986.

Question 4: After the settlement between the SEC and Mr. Boesky was signed, were Boesky's futures positions at any time monitored by the SEC or by the special compliance agent appointed by the SEC pursuant to the settlement agreement?

Answer: Prior to November 14, 1986, these positions were monitored as described above. Beginning on November 17, they were monitored by Gerald F. Rath, and his associates. Mr. Rath and his colleagues received daily position reports showing

Mr. Boesky's transactions and holdings in all of his investment positions, including stock index futures. Mr. Rath had access to information on the size of the futures positions, changes in these positions, and their profitability, on a daily basis. Mr. Boesky and his staff advised him that the positions were held to hedge the portfolio of securities against downward market movements, and, in Mr. Rath's judgment, the size and type of positions appeared reasonably calculated to accomplish that goal. Mr. Boesky's head of research reviewed the futures positions at morning investment meetings of Mr. Boesky and his staff, and periodically wrote memoranda to Mr. Boesky concerning these positions. Mr. Rath reviewed these memoranda and attended nearly all of the morning meetings through early February 1987, by which time Mr. Boesky's futures transactions had virtually ceased.

Question 5: How did or does the special compliance agent inform the SEC of Mr. Boesky's activities in the stock market which are permitted pursuant to paragraph 2 of the settlement agreement?

Answer: During the period of his service, Mr. Rath advised the staff of the Division of Market Regulation of the SEC of Mr. Boesky's positions, including futures positions, essentially on a daily basis. Mr. Rath's service ended shortly after March 13, 1987, when Mr. Boesky ceased his association with the registered broker/dealers he formerly managed.

Question 6: Did any of these reports on Mr. Boesky's stock market activities make reference to Mr. Boesky's futures positions or his trading on stock index futures?

Answer: Yes, as set forth in answer to Question 5.

Question 7: Did Mr. Boesky maintain any positions in options on stock indexes during settlement negotiations or after the settlement between Mr. Boesky and the SEC was signed?

Answer: No.

Question 8: Did the special compliance agent's reports make reference to any trading by Mr. Boesky of options on stock indexes?

Answer: No.

Question 9: If indeed, Mr. Boesky had positions in options on stock indexes which were monitored by the special compliance agent, why would he not have the same interest in monitoring Mr. Boesky's stock-index futures positions?

Answer: As stated in response to Question 4, Mr. Rath did monitor Mr. Boesky's stock-index futures positions during the period of his service.

Question 10: Was there ever any consideration given during the negotiations of the settlement agreement between Mr. Boesky and the SEC to advising the CFTC of such negotiations?

Answer: As noted above, the Commission and the United States Attorney's Office believed that it was critical to maintain the utmost confidentiality regarding Mr. Boesky's agreement with the government in order to obtain the maximum benefit from his cooperation. Accordingly, the agreement was kept on a need-to-know basis within the Commission and the Department of Justice until shortly before the injunction was entered on November 14. At that time, the Commission staff notified other relevant financial agencies, including the CFTC, of the forthcoming announcement in order to assure the stability of the nation's financial markets.

As I am sure you can appreciate, the information on Boesky stock and futures positions is non-public. I understand that, absent extraordinary circumstances, it is not the Committee's practice to disclose publicly any non-public material without prior consultation with the Commission, and that you will follow this practice with respect to these materials.

I believe that this letter answers the questions that you have posed. Should you have any further questions, please contact Richard Ketchum, Director, Division of Market Regulation, at (202) 272-3000.

Sincerely,

David S. Ruder
Chairman

Editor's Note: All nonpublic material is retained in the committee's file.

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